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IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-1523

TRANSCONTINENTAL GAS PIPE LINE CORPORATION,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

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March 28, 1980

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Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

Transcontinental Gas Pipe Line Corporation (Transco) respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the District of Columbia Circuit entered in this proceeding on June 20, 1979.

OPINIONS AND ORDERS BELOW

The opinion of the court of appeals is reported at 606 F.2d 1094 (D.C. Cir. 1979) and appears in Appendix A, at pp. 1a-72a.[1] Its orders (1) denying rehear-

[1] The decision below relates principally to an issue not before the Court in this case. The pertinent portions of the decision below appear in Appendix A, at pp. 60a-62a.

ing and (2) denying suggestion for rehearing *en banc*, entered on October 31, 1979, are not reported and appear in Appendix B, at pp. 73a-76a.

The following orders of the Federal Power Commission [2] are not reported and appear at Appendices C and D, at pp. 77a-118a and 119a-130a, respectively: (1) "Opinion and Order Affirming In Part And Reversing Initial Decision on Reserved Issues and Establishing Just and Reasonable Pipeline Rates," Opinion No. 801, issued May 31, 1977, and (2) "Opinion and Order Denying Rehearing In Most Respects of Opinion and Order Establishing Just and Reasonable Pipeline Rates," Opinion No. 801-A, issued July 29, 1977.

JURISDICTION

The judgment of the United States Court of Appeals for the District of Columbia Circuit was entered on June 20, 1979. A timely petition for rehearing and a suggestion for rehearing *en banc* were denied on October 31, 1979. At the request of Petitioner, this Court, by order of January 17, 1980, extended the date for filing the instant Petition to and including March 29, 1980. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

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[2] On October 1, 1977, pursuant to Section 402 of the Department of Energy Organization Act, Pub. L. No. 95-91, § 402, 91 Stat. 583 (1977) and Executive Order No. 12,009, 3 C.F.R. 142 (1978) the Federal Power Commission (FPC) ceased to exist and its functions and regulatory responsibilities were transferred to the Federal Energy Regulatory Commission (FERC). As used in this petition, the term "Commission" refers to either the FPC or the FERC as the context requires.

QUESTION PRESENTED

Whether the Commission, in setting rates under the prudent investment standard of ratemaking under Section 4 of the Natural Gas Act, may deprive a natural gas pipeline of the opportunity to recover from its customers costs prudently expended on unsuccessful gas supply projects undertaken for the benefit of those customers.

STATUTORY PROVISIONS INVOLVED

Sections 4(a) and 4(e) of the Natural Gas Act, 15 U.S.C. §§ 717c(a) and (e), are set forth in Appendix E, at pp. 131a-132a.

STATEMENT OF THE CASE

Transco is one of the major interstate natural gas pipeline systems in the United States and is subject to regulation by the Commission under the Natural Gas Act. Transco owns and operates extensive pipeline facilities which are utilized to transport gas from its supply area in the Gulf Coast onshore and offshore areas to markets located primarily in the mid-Atlantic region from Atlanta, Georgia, to New York City.

The proceeding from which the instant issue arose involved a general rate increase filed by Transco in July, 1974 pursuant to Section 4(e) of the Natural Gas Act. Insofar as pertinent here, among the capital expenditures reflected by Transco in its filed rates was an amount of $12,448,692 [3] representing preliminary

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[3] The court below referred to four projects with a total cost of $22,309,402 being at issue; however, prior to the Commission's decision, Transco had eliminated from its proposed rate increase $9,860,710 of expenditures related to a proposed synthetic gas plant which had been revived.

expenditures made by Transco on three supplemental gas supply projects involving the gasification of various hydrocarbon feedstocks designed to produce pipeline quality synthetic gas in commercial quantities. These projects were undertaken in an effort to alleviate the shortage of gas on Transco's system which had developed in the early 1970's due to a national shortage of domestic natural gas supplies available to interstate markets and which had required Transco to curtail gas deliveries to its customers commencing in 1971. However, after the 1973-1974 Arab oil embargo, the necessary long-term commitments for feedstocks became unattainable on a basis which would permit the projects to go forward and, consequently, the projects were abandoned.

Ultimately, most of the issues in the general rate case were resolved through the settlement process, but the propriety of Transco's recovery of the costs of the unsuccessful projects was reserved for separate hearing and decision. During trial and in briefs to the administrative law judge and later the Commission, it was Transco's consistent position that the traditional test of prudency should be the basis for determining whether to allow or disallow the cost recovery of the failed projects. At no time during the proceedings did any party question Transco's evidence or contentions concerning the prudence of its expenditures. However, numerous different theories were espoused at various stages of the case by the Commission's staff, the administrative law judge and the Commission itself, all leading to the same result of cost disallowance for the projects. Despite these varying theories, it was not until the last step in the administrative process, the order denying rehearing, that the Commission seized

upon the "used and useful" concept as its basis for disallowance. App. D, pp. 121a-122a.

Transco appealed the Commission's opinions to the court below. In addition to reiterating the appropriateness of the prudent investment standard and citing the Commission's inconsistent precedents which had uniformly permitted natural gas pipelines to recoup the costs of unsuccessful efforts to develop storage fields,[4] Transco also pointed out that the Commission's refusal to allow cost recovery in this case was totally at odds with a contemporaneous electric utility rate decision where the company was allowed to recover the costs of a failed power supply project. *See Southern California Edison Co.* (Opinion No. 821), —— FPC ——, [1977] 13 FED. POWER SERV. (M-B) 5-163, 5-171.

The court below, erroneously characterizing the issue raised by Transco concerning cost recovery of failed projects as "subsidiary" and addressing the matter in an extremely cursory fashion, affirmed the Commission. Without any attempt to reconcile the result of this case with the Commission's precedents allowing cost recovery for abandoned gas and electric projects, and without any attempt to reconcile its own inconsistent precedent in *Washington Gas Light Co.* v. *Baker,* 188 F.2d 11, 19 (D.C. Cir. 1950), the court summarily concluded that "for rate base inclusion expenditures must satisfy not only the necessary condition of prudent investment but also must be 'used and useful' in providing service." App. A, p. 62a.

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[4] *E.g., Midwestern Gas Transmission Co.,* 32 F.P.C. 993 (1964); *Southern Natural Gas Co.,* 29 F.P.C. 323 (1963).

Transco filed a timely petition for rehearing with the court below, along with a suggestion for rehearing *en banc*. Transco also lodged with the court two additional contemporaneous decisions of the Commission in electric rate cases where the recovery of costs expended on failed projects was specifically allowed. *See New England Power Co.* (Opinion No. 49), —— FERC ——, [1979] 18 FED. POWER SERV. (M-B) 5-484, 5-510; *Southern California Edison Co.* (Opinion No. 62), —— FERC ——, [1979] 18 FED. POWER SERV. (M-B) 5-980, 5-985 to 5-986. Although the court requested and received a response from the Commission to Transco's petition for rehearing, on October 31, 1979, the court denied rehearing and the suggestion for rehearing *en banc* without comment. App. B, pp. 207a-210a.

REASONS FOR GRANTING THE WRIT

1. The Resolution Of The Question Presented In This Case Will Determine Whether The Gas Pipeline Industry Will Be Able To Initiate Supplemental Gas Supply Projects To Maintain Service To Gas Consumers

In the years immediately after World War II, the natural gas industry began to experience a period of explosive growth, with pipelines being constructed into virtually every sector of the lower forty-eight states. This expansion, aided by extremely low wellhead prices for gas which previously had been principally a by-product of oil production and had largely been flared into the atmosphere, continued unabated into the late 1960's, at which point natural gas supplied about one-third of the energy needs of the country.

Commencing in 1970, shortages of natural gas began to appear in the interstate markets and curtailments

of service began to be felt in scattered areas of the country. These curtailments continued and increased throughout the early and mid-1970's until, in combination with a severely cold winter east of the Rocky Mountains, the majority of the country suffered a natural gas emergency condition in the 1976-1977 winter, resulting in numerous plant and school closings and significant discomfort to large segments of the populace.[5]

During the halcyon days of the 1950's and 1960's, the gas industry was almost entirely dependent upon domestic natural gas producers for their supplies. In the face of prospects in the early 1970's for increasing shortages of domestic supplies, pipelines such as Transco began to look for means of alleviating these shortages through institution of non-conventional supply sources such as import projects and various potential gasification processes from coal and liquid petroleum feedstocks.

In Transco's case, it explored numerous supplemental supply projects including the importation of liquefied natural gas (LNG) from overseas sources, importation of Canadian and Mexican gas, and the manufacture of high-Btu synthetic gas (SNG) from various hydrocarbon feedstocks. Many of these projects such as the three gasification projects at issue in this pro-

[5] In the last two years, deliverable gas supplies have improved due to a number of factors, including increased domestic well drilling and passage of the Natural Gas Policy Act of 1978, 15 U.S.C. § 3301 *et seq.*, which afforded parity of access by interstate pipelines to intrastate sources of gas supply. It should be noted, however, that, since the national shortage of gas first appeared, the country has consistently used more gas than has been found, so that known reserves of gas in the lower 48 states are decidedly less today than they were in 1970.

ceeding were high risk ventures totally unlike the conventional underground pipelines built to carry gas supplies from wellhead to market which had been the principal function of pipeline companies prior to the onset of the national shortage. Nevertheless, although pipelines' rates were regulated by the Federal Power Commission on a strict prudent investment cost basis which would preclude the potentially large unregulated rewards of successful high risk ventures, pipelines embarked on numerous of these high risk ventures in full expectation—based upon their understanding of the prudent investment standard of ratemaking theretofore consistently applied—that prudent expenditures would be recovered whether or not the projects proved to be successful. The Commission's decision in this case, however, proved those expectations to be illusory.

The narrow question in this case, whether pipelines which are regulated on the prudent investment method of ratemaking can be required to absorb the cost of their prudent but unsuccessful projects, is important far beyond the immediate impact upon Transco or even the other pipelines whose rate treatment in this area may be dependent upon the outcome of this case. The true significance of this case lies in its impact upon the future conduct of pipelines in entering into high risk ventures in efforts to maintain service to their customers in the face of the shortage of conventional natural gas supplies. If the Commission's decision is upheld, venture capital will simply not be forthcoming to assume the high risks of loss for project failure in view of the meager reward of a low risk utility return on invested capital if the projects prove

to be successful. This means ultimately that supplemental energy projects will be undertaken, if at all, by (1) unregulated enterprises whose risks and rewards are dictated by the free market place, (2) electric utilities and other regulated enterprises whose investments are in fact protected against project failure by the regulators (see pp. 13-14, *infra*) or (3) the federal government. In any event, the question presented has great significance for the future role of the gas pipeline industry in development of supplemental energy sources for the country and, therefore, it is a question which should be resolved by this Court.

2. The Commission's Claimed Authority To Disallow Recovery Of Pipelines' Prudent Expenditures Raises Important Questions Of Confiscation And Proper Administration Of Federal Regulatory Statutes

In this Section, we will show that the Commission is arbitrarily and capriciously reaching diametrically opposite results with respect to cost recovery of unsuccessful projects by gas and electric companies under its jurisdiction. Under the circumstances, it is submitted that this Court should establish the rule of law which will be applied by regulatory agencies in a consistent fashion, and which can be relied upon by utilities and the financial community in their investment decisions. Otherwise, regulatory agencies such as the Commission will be free to permit or deny cost recovery on the basis of whichever result suits its whim at the moment. Moreover, we will show that to the extent that gas pipelines are not allowed to recover the costs of their prudent expenditures, the in-

evitable result is confiscation in violation of the due process clause of the Constitution.[6]

In the instant case, the Commission in the first instance and the court in its cursory affirmance seemed to assume, without any meaningful discussion of the precedents or rationale, that the "used and useful" concept was a part of the traditional test for cost recovery.[7] To the contrary, we submit that the cases demonstrate that the used and useful concept is inconsistent with the Commission's prudent investment standard for cost recovery, and when the concepts are applied as a dual test, confiscation of property devoted to public service results.

Since its prerogative to do so was confirmed in *F.P.C.* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944), the Commission has consistently employed the prudent investment theory of ratemaking based on original

[6] In another case involving efforts to augment dwindling gas supplies, *Public Service Commission of New York* v. *F.P.C.*, 467 F.2d 361, 370 (D.C. Cir. 1972), another panel of the court below aptly summarized the confiscation issue as follows:

> [U]ltimately the consumers must be ready to shoulder the costs of such operations, if they are necessary to supply them with power. This is so because *under the due process clause of the Constitution no public utility could be compelled to absorb its own costs and not pass them on to the consumers.* (Emphasis supplied.)

[7] In a footnote, the court below cited as its only authority *Tennessee Gas Pipeline Co.*, 48 FPC 149 (1972) *aff'd, Tennessee Gas Pipeline Co.* v. *F.P.C.*, 487 F.2d 1189 (1973); that case, however, has nothing to do with the used and useful concept.

cost.[8] In the agency proceeding in the *Hope* case, the Commission explained that *investment* itself was the critical distinction between the prudent investment and fair value methodologies:

> With the decline in favor of 'fair value' as the only mode of public utility rate regulation, its keystone, reproduction cost, crumbles. *Bona fide investment figures now become all important in the regulation of rates.*

Hope Natural Gas Co., 3 FPC 150, 164 (1942) (emphasis supplied). Thus, whether a *bona fide* investment becomes used and useful is immaterial to cost recovery under the Commission's chosen methodology.[9]

The prudent investment standard for utility ratemaking is grounded on original cost; it differs from the fair value (or reproduction cost new) theory of rate

[8] Justice Brandeis explained the prudent investment theory, and its consequences, as follows:

> *The thing devoted by the investor* to the public use is not specific property, tangible and intangible, but *capital embarked in the enterprise. Upon the capital so invested the federal Constitution guarantees to the utility the opportunity to earn a fair return.* (Emphasis supplied.)

Missouri ex rel. *Southwestern Bell Telephone Co.* v. *Public Service Commission*, 262 U.S. 276, 290 (1923) (concurring opinion).

[9] It is not suggested that the used and useful concept has no significance in the regulatory scheme under the Natural Gas Act. The Commission typically employs the used and useful test to distinguish between plant in service and construction work in progress (CWIP), the latter being capitalized and included in rate base only upon completion of construction. The phrase also has relevance in connection with establishment of depreciation rates whose purpose is recovery of plant investment over the useful life of the property.

base valuation in that it establishes rates on the basis of the actual (*i.e.*, original) costs incurred by the utility, whereas the fair value method is premised on an estimate of the current value of utility property which, because of factors such as appreciation in value due to inflation, may far exceed actual original cost.

This basic difference in the rate base valuation theories of original cost (prudent investment) versus reproduction cost new (fair value) leads to different consequences where expenditures are excluded from rate base under the two methods. Exclusion of abandoned or unsuccessful projects from rate base under the fair value method does not mean that the utility will not be allowed a fair return, because unlike the result reached under the original cost method, the utility's remaining plant investment may receive a current valuation much higher than original cost due to inflation. In other words, the effect of rate base exclusion can be offset by a finding of fair value sufficient to avoid a confiscatory result.[10] By way of contrast, such is *not* the case where the prudent investment (original cost) method is utilized, since there is no latitude in a

[10] And, under the fair value (reproduction cost new) test, there is no reason that property not used or useful should be included in rate base, as explained by this Court in *Los Angeles Gas Co.* v. *Railroad Commission of California*, 289 U.S. 287, 311 (1932):

> Whatever may be said of the propriety of including this entire [abandoned manufactured] gas plant in valuation based on historical costs, in the light of prudent investment, we perceive no reason for embracing unnecessary facilities in an estimate of cost of reproduction.

It is also understandable that the origin of the used and useful concept can be traced to the fair value method rather than to the prudent investment theory. In *Smyth* v. *Ames*, 169 U.S. 466 (1898), this Court made the "fair value of the property being *used* by [the utility] for the convenience of the public" its basis for determining reasonableness of rates. *Id.* at 546 (emphasis supplied).

valuation based on actual costs. Therefore, rate base exclusion of prudent expenditures under the original cost methodology *will result in confiscatory rates* unless the utility's rate of return has taken into account the inevitability that some high risk ventures such as those involved in this case will fail. *See Washington Gas Light Co.* v. *Baker*, 188 F.2d at 19-20. In that regard, however, the Commission can point to no instance where, in setting pipeline rates of return, it has given consideration to this entirely new dimension of potential capital losses due to the high risk nature of supplemental gas projects.

In stark contrast to the Commission's disallowance of gas pipelines' prudent expenditures for failed projects designed to offset declining gas supplies, electric utilities are permitted by the same Commission to this very day to recover expenditures on power supply projects that are abandoned. *See Southern California Edison Co.* (Opinion No. 62), —— FERC ——, [1979] 18 FED. POWER SERV. 5-980; *New England Power Co.* (Opinion No. 49), —— FERC ——, [1979] 18 FED. POWER SERV. 5-484; and *Southern California Edison Co.* (Opinion No. 821), —— FPC ——, [1977] 13 FED. POWER SERV. 5-163. The favorable treatment of electric utilities' prudent expenditures in failed projects is entirely proper, for the reasons discussed above. However, since the pertinent provisions of the Federal Power Act and the Natural Gas Act under which rates are regulated are virtually identical,[11] there can be no justification for the diametrically opposite treatment which the Commission affords the two classes of public utilities subject to its jurisdiction in connection with

[11] *See F.P.C.* v. *Sierra Pacific Power Co.*, 350 U.S. 348, 350-351 (1956).

expenditures on unsuccessful projects. The Commission made no effort to explain or reconcile this inconsistent treatment and, we submit, there is no basis for different ground rules and results for the two industries which are in competition for energy markets. Such actions are neither rational nor defensible.

Although this Court's decision in *Hope, supra,* 320 U.S. at 602, does not bind the Commission to any particular theory of rate base valuation, it is submitted that the theory chosen by the agency must be applied consistently and must result in an opportunity to recover costs, including a reasonable return on investment. However, unless this Court accepts this case and provides the necessary guidance to regulatory agencies, they will be free to adopt whichever result suits the particular whim of the moment.

Because of the important question of confiscation under the due process clause of the Constitution, and the proper administration of the federal regulatory statutes administered by the respondent Commission, this Court should resolve the question presented.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted,

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APPENDIX A

United States Court of Appeals

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 77-1496

TENNESSEE GAS PIPELINE COMPANY,
a division of Tenneco Inc., PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION, RESPONDENT

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK
ENTEX, INC.
COLUMBIA GAS TRANSMISSION COMPANY
PUBLIC SERVICE ELECTRIC AND GAS COMPANY
NORTHERN ILLLINOIS GAS COMPANY
NEW ENGLAND CUSTOMER GROUP (BAY STATE GAS CO.),
INTERVENORS

No. 77-1498

PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,
PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION, RESPONDENT

TENNESSEE GAS PIPELINE COMPANY
COLUMBIA GAS TRANSMISSION CORPORATION
NEW ENGLAND CUSTOMER GROUP, ET AL.
NORTHERN ILLINOIS GAS CO.
PUBLIC SERVICE ELECTRIC AND GAS CO., INTERVENORS

No. 77-1653

INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA,
PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION, RESPONDENT

COLUMBIA GAS TRANSMISSION CORP.
TENNESSEE GAS PIPELINE CO.
PUBLIC SERVICE ELECTRIC AND GAS CO.
PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,
INTERVENORS

No. 77-1712

TRANSCONTINENTAL GAS PIPE LINE CORPORATION,
PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION, RESPONDENT

COLUMBIA GAS TRANSMISSION CORP.
UNITED CITIES GAS COMPANY
PUBLIC SERVICE ELECTRIC & GAS COMPANY
TENNESSEE GAS PIPELINE CO.
PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK,
INTERVENORS

No. 77-1719

MICHIGAN WISCONSIN PIPE LINE COMPANY, PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION, RESPONDENT

WISCONSIN NATURAL GAS CO.
ASSOCIATED NATURAL GAS CO.
MICHIGAN GAS UTILITIES CO., INTERVENORS

Petitions for Review of Orders of the
Federal Energy Regulatory Commission

Argued September 29, 1978

Decided June 20, 1979

Harold L. Talisman with whom *Melvin Richter, Dale A. Wright, Patricia A. Curran, Terence J. Collins, Gregory Grady* and *Lilyan G. Sibert* were on the brief, for Tennessee Gas Pipeline Company, petitioner in No. 77-1496, intervenor in Nos. 77-1498, 77-1653 and 77-1712 and amicus curiae in No. 77-1719.

Richard J. Flynn with whom *Frederic G. Berner, Jr.* and *Charles V. Shannon* were on the brief, for Michigan Wisconsin Pipe Line Company, petitioner in No. 77-1719 and amicus curiae in No. 77-1496.

Thomas F. Ryan, Jr. with whom *Robert G. Hardy* was on the brief, for Transcontinental Gas Pipe Line Corporation, petitioner in No. 77-1712.

Edward W. Hengerer and *Norman A. Pedersen*, Attorneys, Federal Energy Regulatory Commission, with whom *Howard E. Shapiro*, Solicitor, and *Philip R. Tel-*

leen, Attorney, Federal Energy Regulatory Commission, were on the brief, for respondents.

Richard A. Solomon with whom *Peter H. Schiff* and *Sheila S. Hollis* were on the brief, for Public Service Commission of the State of New York, petitioner in No. 77-1498 and intervenor in Nos. 77-1496 and 77-1712.

Jerome J. McGrath, John H. Cheatham, III and *J. Evans Attwell* were on the brief, for petitioner Interstate Natural Gas Association of America in No. 77-1653.

John D. Daly and *Giles D. H. Snyder* and *Stephen J. Small* were on the brief for intervenor Columbia Gas Transmission Corporation in Nos. 77-1496, 77-1498, 77-1653 and 77-1712.

Robert H. Gorske was on the brief, for intervenor Wisconsin Natural Gas Company in No. 77-1719.

Irving Jacob Golub, Stephen A. Wakefield, William B. Cassin and *Phillip D. Endom* were on the brief, for amicus curiae United Gas Pipe Line Company in Nos. 77-1496, 77-1498 and 77-1653.

Also *Allan Abbot Tuttle, Robert W. Purdue* and *Dennis Lane*, Attorneys, Federal Energy Regulatory Commission, entered appearances for respondent.

Also *Paul W. Fox* and *John W. Glendening, Jr.* for intervenor New England Customer Group in Nos. 77-1496 and 77-1498.

Also *J. Stanley Stroud* entered an appearance for intervenor Northern Illinois Gas Company in Nos. 77-1496 and 77-1498.

Also *Carl W. Ulrich, William R. Duff, Edward S. Kirby* and *James R. Lacey* entered appearances for intervenor Public Service Electric and Gas Company in Nos. 77-1496, 77-1498, 77-1653 and 77-1712.

Also *Michael J. Manning* and *Patrick J. Keeley* entered appearances for intervenor Entex, Inc. in No. 77-1496.

Also *Jack M. Irion* entered an appearance for intervenor United Cities Gas Company in No. 77-1712.

Also *Richard M. Merriman, J. Richard Tiano* and *Richard T. Witt* entered appearances for intervenors Associated Natural Gas Company and Michigan Gas Utilities Company in No. 77-1719.

Before: LEVENTHAL and WILKEY, *Circuit Judges*, and HAROLD GREENE,* *District Judge*, United States District Court for the District of Columbia.

Opinion for the Court filed by *Circuit Judge* LEVENTHAL, in which *Circuit Judge* WILKEY and *District Judge* GREENE join.

Concurring opinion filed by *Circuit Judge* WILKEY.

LEVENTHAL, *Circuit Judge*: We consider petitions of natural gas pipeline companies[1] for review of Federal Power Commission[2] rate making orders. The common

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* Sitting by designation pursuant to 28 U.S.C. § 292(a) (1976).

[1] In addition to the principal pipeline petitioners, Tennessee Gas Pipeline Company (No. 77-1496) ("Tennessee"), Transcontinental Gas Pipe Line Corporation (No. 77-1712) ("Transco"), Michigan Wisconsin Pipe Line Company (No. 77-1719) ("Michigan-Wisconsin"), there are petitions by the Interstate Natural Gas Association of America (No. 77-1653) ("INGAA"), Columbia Gas Transmission Corporation (Intervenor in No. 77-1496 *et al.*) ("Columbia"), and the Public Service Commission of the State of New York (No. 77-1498) ("PSC"). There also have been various cross-interventions by the parties.

[2] The Federal Power Commission went out of existence in the fall of 1977. The Department of Energy Reorganization Act of 1977, P.L. 95-91, 91 Stat. 565, *codified at* 42 U.S.C. §§ 7107 *ea seq.* (1978), transferred most of the FPC's func-

element in these companion cases is the treatment of "advance payments," pre-payments for future deliveries of natural gas made by the pipelines in the context of an experimental "advance payment program," which was designed to facilitate capital formation by producers to finance development and production of additional gas supplies, thus helping to alleviate the natural gas shortage. In formulating "just and reasonable" pipeline rates in each case, the Commission denied rate base treatment for various expenditures. It deferred inclusion in rate base for advance payments made during the test period and not appropriately expended by the recipient producers within 30-days of the close of that period. We find that the Commission failed to administer the advance payment program with the required flexibility and thus remand the treatment of advance payments for further consideration. In certain respects, as will be noted, we affirm the Commission's other determinations.

I. Front-End Advance Payments to Domestic Producers

A. *General Background*

The unhappy saga of the advance payment program has been detailed by this court on other occasions.[3] Con-

tions, including its rate making authority under both the Federal Power Act and the Natural Gas Act, to the newly created Federal Energy Regulatory Commission (FERC). 42 U.S.C.A. §§ 7172(a)(1)(B), (C) (1977). This change in administration has no effect on the instant litigation, save for the appropriate substitution of parties.

[3] *See* The Second National Natural Gas Rate Cases, 186 U.S.App.D.C. 23, 59-64, 567 F.2d 1016, 1052-57 (1977), *cert. denied*, 435 U.S. 907 (1978); United Gas Pipe Line Co. v. FPC, 179 U.S.App.D.C. 274, 276, 551 F.2d 460, 462 (1977); Michigan Wisconsin Gas Pipe Line Co. v. FPC, 171 U.S.App. D.C. 352, 353-54, 520 F.2d 84, 85-86 (1975); Public Service Com'n, State of N.Y. v. FPC, 167 U.S.App.D.C. 100, 511 F.2d 338 (1975) [hereafter cited as "*PSC (Advance Payments) II*"]; Public Service Com'n, State of N.Y. v. FPC, 151 U.S. App.D.C. 307, 467 F.2d 361 (1972) [hereafter cited as "*PSC (Advance Payments) I*"].

ceived as one method of alleviating the impending natural gas shortage, the program was initiated in 1970 and was governed successively by a series of five "advance payment orders" until its termination at the end of 1975.[4] As originally formulated and approved by this court, the program was designed to facilitate capital formation by producers to finance development and production of new gas supplies.[5] It was contemplated that pipelines would provide production capital in the form

[4] Order No. 410, Accounting and Rate Treatment of Advance Payments to Suppliers for Gas and Amending F.P.C. Form No. 2, Docket No. R-380, 44 FPC 1142 (1970) (governing advances made pursuant to contracts entered after October 2, 1970) [hereafter cited as "Order No. 410"]; Order No. 410-A, Accounting and Rate Treatment of Advance Payments to Suppliers for Gas, and Amending F.P.C. Form No. 2, Docket No. R-380, 45 FPC 135 (1971) (amending the treatment of advance payments governed by Order No. 410) [hereafter cited as "Order No. 410-A"]; Order No. 441, Accounting and Rate Treatment of Advance Payments to Suppliers for Exploration and Lease Acquisition of Gas Producing Properties, Docket No. 4-411, 46 FPC 1178 (1971) (governing advance payments contracts executed between November 10, 1971 and December 31, 1972) [hereafter cited as "Order No. 441"]; Order No. 465, Accounting and Rate Treatment of Advance Payments Included in Account 166, Advance Payments for Gas Development and Production, Docket No. R-411, 48 FPC 1550 (1972) (governing contracts executed between January 1, 1973 and December 31, 1973) [hereafter cited as "Order No. 465"]; Order No. 499, Accounting and Rate Treatment of Advances Included in Account No. 166, Advances for Gas Exploration, Development and Production, Docket No. RM74-4, 50 FPC 2111 (1973) (governing contracts executed between January 1, 1974 and December 31, 1975) [hereafter cited as "Order No. 499"].

[5] *PSC (Advance Payments) I, supra* note 3, 151 U.S.App. D.C. at 309, 467 F.2d at 363.

of pre-payments to producers (advance payments) for future deliveries of natural gas. The order launching the program provided that such payments could be capitalized and included in the pipeline's rate base subject to qualifications, including the requirement that advances must be "reasonable and appropriate." [6] The orders also specified those producer expenditures permissible under the program ("qualifying expenditures"). Producers could be expected to seek advance payments because the advances would provide them with a source of interest-free capital.[7] It was anticipated that pipeline participation in the program also would be assured if pipeline rates could reflect a return on qualifying advance payments.[8] Current purchasers from the pipeline would shoulder, in the rates they paid, the "carrying charges" on these interest-free loans to producers, though the benefits from expansion of natural gas supplies would

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[6] Order No. 410, *supra* note 4, 44 FPC at 1144. Advance payments were to be drawn down and removed from Account 166, Advance Payments for Gas, as gas deliveries commenced or as the pipeline was reimbursed in consideration other than gas. The significant express qualifications governing advances under the various orders are described in note 34 *infra*.

[7] *See* Order No. 465, *supra* note 4, 48 FPC at 1554.

[8] The "cost" to the pipeline of an advance payment was the cost of financing the amount advanced, a factor principally determined by interest rates in the bond market. The "cost" to rate payers was determined by the rate of return allowed on the pipeline's rate base. A differential between the allowed rate of return and the prevailing interest rate in capital markets provided some opportunity for successful arbitrage, but as interest rates rose during the relevant period this incentive was minimized. The principal incentive for pipeline participation lay in their ability to secure gas reserves for the future while transferring to the rate payer the added cost of making pre-payments (advance payments) for the gas.

flow to future, not current, rate payers.[9] This departure from the usual rule of public utility regulation (that current rates should reflect the cost of supplying service to current rate payers) was thought justified by the "public interest in enlarging the field supply of natural gas, needed for existing facilities and contracts." [10]

The program was conditionally approved by this court in *Public Service Commission, State of New York* v. *FPC* [*PSC (Advance Payments) I*],[11] as a "justifiable experiment in the continuing search for solutions to our nation's critical shortage of natural gas." [12] Resolving doubts in favor of the program, we stressed its experi-

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[9] Qualifying advance payments had to be made prior to deliveries under the advance payment contract. *See, e.g.*, Order No. 465, *supra* note 4, 48 FPC at 1556. Substantial lag times were inevitable between the date of the advance and its full repayment in gas, especially if the advance were made to fund exploration or other pre-production producer expenditures. *See id.* at 1553 (FPC assumption that all pre-Order No. 441 advances are fully recovered on the average in five years, with a one-year lag between the advance and commencement of recoupment). Where "front-end" advances were involved, the time between the date of advance and its full repayment in gas was considerably extended. For example, most of the advance payments excluded for a period from Tennessee's rate base, though advanced in 1973, were not even fully utilized by the recipient producers until 1975, and the weighted average lag time between the end of the applicable test period and the date when Tennessee's producers would require the advance to cover costs was calculated to be 22.8 months. JA in No. 77-1496, *et al.* at 254, 256 (testimony of Staff witness Robert H. Benna, unrebutted by petitioners in this respect); *see* FERC Br. in No. 77-1496, *et al.* at 36.

[10] *PSC (Advance Payments) I*, *supra* note 3, at 316, 467 F.2d at 370.

[11] 151 U.S.App.D.C. 307, 467 F.2d 361 (1972).

[12] *Id.* at 317, 467 F.2d at 371 (on petition for rehearing).

mental character and the need for flexibility and re-evaluation as it evolved. We perceived the three advance payment orders that had been issued as of that time [13] "as an on-going effort by the FPC to determine experimentally the proper solution with regard to advance payments to help alleviate the gas shortage," and we were "impressed with the fact that the FPC [had] demonstrated a willingness to assimilate criticism . . . and adjust its treatment of advance payments to conform with the realities of the natural gas market." [14] We emphasized that the agency, in reaching "an accommodation of conflicting interests," was "making policy decisions of the type it was created to make." [15] But this judicial approval was predicated on the Commission's willingness to continue to respond to "the realities of the natural gas market" and to modify the program in light of accumulated experience. We reiterated these concerns in our response to New York Public Service Commission's petition for rehearing.[16]

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[13] Orders No. 410, No. 410-A, and No. 441, *supra* note 4.

[14] *PSC (Advance Payments) I*, *supra* note 3, 151 U.S.App. D.C. at 313, 467 F.2d at 367.

[15] *Id.*

[16] *Id.* at 317, 467 F.2d at 371:

> One of the important factors in reaching our decision was the temporary character of the FPC order under review (Order 441 remains in effect only through 31 December 1972), and our belief that it represented a justifiable experiment in the continuing search for solutions to our nation's critical shortage of natural gas. . . . Fundamental to the concept of any experiment is the assumption that the data developed from the experience thereunder will be subjected to meaningful review, analysis, and evaluation before the experimental practice is allowed to continue or to become institutionalized as a more permanent procedure. . . . We would accordingly expect that the FPC will not continue, or extend the effective date of, the practices authorized by Order 441 without further proceedings in which New York and all other interested parties will be given the opportunity to demonstrate the effectiveness or the futility of this experiment.

The advance payment order approved by our March 1972 ruling in *PSC (Advance Payments) I* expired at the end of that year. It was replaced in turn by the two orders pertinent to the instant cases, Order No. 465,[17] governing advance payments made during 1973, and Order No. 499,[18] governing the 1974-75 period. When the program again came before this court in *Public Service Commission, State of New York* v. *FPC* [*PSC (Advance Payments) II*],[19] we ruled that the Commission had failed in its obligation "to engage in 'meaningful review, analysis and evaluation' of the experience under the advance payments program" [20] and to "adjust its treatment of advance payments to conform with the realities of the natural gas market." [21] In our view, "[t]he data presented by the Commission as a justification of its repeated extensions of the advance payments program provide[d] an inadequate basis from which 'to determine whether its justifying objectives [were] being satisfactorily met at an acceptable level of ultimate economic cost to the nation's gas consumers.'" [22] Accordingly, we remanded the record for further evidence and

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[17] *See* note 4 *supra*.

[18] *See id.*

[19] 167 U.S.App.D.C. 100, 511 F.2d 338 (1975).

[20] *Id.* at 104, 511 F.2d at 342 (quoting from *PSC (Advance Payments) I* statement on petition for rehearing, note 16 *supra*).

[21] *Id.* at 105, 511 F.2d at 343.

[22] *Id.* at 104, 511 F.2d at 342 (quoting from *PSC (Advance Payments) I* statement on petition for rehearing, note 16 *supra*).

consideration by the FPC. In light of its subsequent reevaluation, the agency allowed the program to expire upon termination of Order No. 499 on December 31, 1975.[23]

Although the program has been terminated, existing advance payment contracts retain their vitality,[24] and continued administration is required as pipelines file with the FERC for jurisdictional rate increases. In such rate-making proceedings the Commission has been called upon to determine whether specific advance payments qualify for rate base treatment under the terms of the applicable advance payment orders. This is the posture of the cases here under review.

B. *Nature of Front-end Advance Payments*

The central controversy in these cases involves the temporary exclusion from rate base of certain "front-end advance payments" made in the United States.[25]

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[23] *See* Advances for Gas Exploration, Development and Production, Docket Nos. R-411 & RM74-4 (orders issued Dec. 31, 1975 and Feb. 27, 1976).

[24] *Id.*

[25] The first of the two advance payment orders pertinent to these cases restricted its coverage to advances made to producers within the lower 48 states. Order No. 465, *supra* note 4, 50 FPC at 1555. The second pertinent order made accommodation for advances to producers in Alaska. Order No. 499, *supra* note 4, 50 FPC at 2116.

One of these cases, No. 77-1496 *et al.*, also involves exclusion from rate base of advances made to Canadian producers, but the Commission's decision was controlled by different considerations since advances to producers on the North American continent outside the United States were eligible for rate base treatment but only on a case-by-case basis. Advances to Suppliers for Gas Outside Continental United States, Docket No. R-466, 38 Fed. Reg. 1055-56 (1973) (notice of rulemaking). This issue is treated in section II-A *infra*.

These are a particular class of "advance payments." In general, the program provided for "advance payments" in the sense that the payments were authorized to be made in advance of the delivery of gas supplies. The focus of concern in these cases is the so-called "front-end advance payment," which identifies a transfer to the producer not only prior to gas deliveries, but also prior to any producer expenditures associated with ultimate production of the gas.

An advance payment has two aspects, and provides a dual benefit to the recipient producer. First, it is a *source of capital*, which supplements the funds available to producers for development and production expenditures. It is a loan, but one shaped as a pre-payment to be credited against the purchase price of gas that will flow from successful development efforts. Second, it is an *interest-free* loan. When an advance payment substitutes for capital raised in financial markets, it relieves the producer of financing costs. There is an extra benefit to the producer in that the rate set for the producer by the Commission incorporates an allowance for financing cost, and no reduction in that rate is required on account of the fact that part of the producer's financing is cost-free.[26] Thus, advance payments provide a

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[26] *See, e.g.*, JA in No. 77-1712 at 148-49, Transcontinental Gas Pipe Line Corporation, Docket Nos. RP74-48 and PR75-3, Presiding Administrative Law Judge's Initial Decision on Reserved Issues 31-32 (Dec. 22, 1975) [hereafter cited as "Transcontinental Initial Decision"] ("[T]he producer has interest-free use of the funds until the day they must be spent on eliciting gas, and this is a substantial bonus added to the price he will receive for the gas from the pipeline. The pipeline receives no discount upon that price because its funds financed the producer's venture. And the full price, commonly the highest price permissible under FPC regulations, is ultimately paid by the pipeline's customers."); JA in No. 77-1719 at 111, Michigan Wisconsin Pipe Line Co., Docket No. CP70-

"bonus" to producers in the amount of the interest factor, an amount which is never refunded.

In the Commission's view, the objective of the advance payment program was to expedite the development of gas supply through the mechanism of providing producers an additional *source of capital.* In theory, the increased availability of capital would encourage investment, which in turn would yield additional gas supply. The interest factor, and the "bonus" which it provided to producers, has been construed as a subsidiary element designed to provide incentive for producer participation, a necessary cost to achieve the desired benefit.[27]

The Commission has come to focus on front-end advance payments as providing a still further bonus to the producer—not only the interest-free availability of funds during use for gas development, but their availability for some period prior to the time of "qualifying expenditure" by the producer. The Commission has recognized that capital formation and the pertinent qualifying expenditure may be facilitated by the transfer of an advance to the producer a "reasonable time" prior to the expenditure. However, the Commission has endeavored through administration of the program to protect rate payers from the cost of advance payments held by producers for any "unreasonable" front-end period. Advance payments that were made (in the Commission's view) an "unreasonable" time prior to their appropriate expendi-

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22, Initial Decision Upon Inclusion of Advance Payments in Rate Base 7 (Feb. 27, 1976) [hereafter cited as "Michigan-Wisconsin Initial Decision"], JA in No. 77-1719 at 111 ("The use of money for a period of time is itself worth money. The advance payments at issue in this proceeding necessarily involve the payment of substantial additional compensation to the producers above and beyond the established price for gas that they may discover and sell to the pipeline.").

[27] *See* Order No. 465, *supra* note 4, 48 FPC at 1554.

ture have been labeled "extravagant" by the agency. Since the term "extravagant" begs the question, these payments will be referred to in this opinion as "extended front-end advance payments" or "extended front-end advances."

C. *The Critical Timing Requirement*

Distilled to its essence, this case involves two questions: (1) whether the rate base treatment contemplated by the program was inherently limited to advance payments made no more than a "reasonable time" prior to their appropriate expenditure; and, (2) whether, if such a limitation existed, the Commission acted within its discretion in defining the permissible interval solely in terms of traditional line-of-credit financing practices.

The timing element has assumed paramount importance due to the response of both pipelines and producers to the realities of the natural gas market in the context of the advance payment program. In an unregulated economic environment, a period of supply shortage may be expected to stimulate a rise in price until supply and demand are once again in equilibrium. But on sales of natural gas within FERC jurisdiction, both producers and pipelines are foreclosed from an unencumbered response to economic forces. Unless specifically excepted, producers must sell gas, and pipelines must buy it, at regulated rates that may fall well below a "free-market" price.[28] Further, the law imposes on the pipelines an

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[28] Section 4(a) of the Natural Gas Act, 15 U.S.C. § 717c(a) (1976), provides that "[a]ll rates and charges made, demanded, or received . . . shall be just and reasonable, and any such rate or charge that is not just and reasonable is declared to be unlawful." Section 5, 15 U.S.C. § 717d (1976), authorizes the Commission to review rates and set them at just and reasonable levels. Section 7(c), 15 U.S.C. § 717f(c) (1976),

enforceable obligation to resist any temptation to acquiesce in unlawful producer demands and to bid against each other for available supplies of gas by offering higher prices or their equivalents.[29] Still, the sanctions available to the FERC have their limitations, and even in the regulatory context market pressures retain some vitality.[30]

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requires that new gas be sold under certificates of "public convenience and necessity." The Commission's power to exempt producers and pipelines from the regime of just and reasonable rate regulation is limited. *See generally* FPC v. Texaco Inc., 417 U.S. 380 (1974); Consumer Federation of America v. FPC, 169 U.S.App.D.C. 116, 515 F.2d 347, *cert. denied*, 423 U.S. 906 (1975).

[29] *See* Natural Gas Act, §§ 20, 21, 15 U.S.C. §§ 717s, 717t (1976).

[30] Pursuant to section 4(e) of the Natural Gas Act, 15 U.S.C. § 717c(e) (1976), the Commission may suspend a filing for a jurisdictional rate for up to five months. At the end of the suspension period, the rate may go into effect, subject to refund. Pipeline expenditures for the purchase of gas beyond just and reasonable prices may be denied reimbursement (*i.e.*, ordered for refund) and the pipeline's investors, rather than its rate payers, may have to bear the disallowed cost. Section 20 of the Act, 15 U.S.C. § 717s (1976), allows the Commission to seek an injunction from a district court to restrain on-going or prospective violations of the Act's provisions. Section 21, 15 U.S.C. § 717t (1976), subjects to criminal penalties "[a]ny person who willfully and knowingly does or causes or suffers to be done any act, matter, or thing in this chapter prohibited or declared to be unlawful," and subjects to modest per diem fines "[a]ny person who willfully and knowingly violates any rule, regulation, restriction, condition, or order made or imposed by the Commission under authority of this chapter." Despite these deterrents to the knowing payment of higher than just and reasonable prices for natural gas, the Commission cannot take the ill-gotten gas away from the offending pipeline once it has flowed to its customers. One may anticipate circumstances where a pipeline's investors might determine in their sound business

The advance payment orders did not specify the permissible interval between the advance and its appropriate expenditure. Perhaps emboldened by this indefiniteness, producers pressed their bargaining advantage, inducing pipelines to make advances long before the funds were used for qualifying expenditures. These advances, certain of which the Commission has labeled "extravagant," and which we refer to as "extended front-end advances," gave producers valuable interest-free funds for their unrestricted use during the interim period. By this mechanism the price of natural gas effectively was raised above the regulatory ceiling.[31] Competition for needed gas supplies motivated pipelines to acquiesce in exorbitant producer demands. The belief (or hope) that the Commission would permit rate-base treatment of extended front-end advances, thus passing on the competitive cost to the rate payers, may have contributed to the pipelines' weakened resistance. Whatever the causes, extended front-end advance payments emerged in the market and are referred to in the testimony of witnesses for the pipelines as a "term of trade" arising during the period relevant to these cases.[32]

The Commission has administered the advance payment program to defer inclusion in rate base of a pipeline's front-end advances until the test period in which those advances were used by the recipient producers for appropriate purposes. The Commission has relied on its construction of the general objectives of the program and on the administrative discretion inherent in an announced general policy that it would include in the rate

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judgment to take the risks associated with obtaining needed gas supplies, at least where there is a colorable legal argument that questionable expenditures are permissible.

[31] *See* note 26 *supra*.

[32] *See, e.g.*, Opinion No. 769-A, Tennessee Gas Pipeline Company, Docket No. RP73-113, Opinion and Order Denying Rehearing 3 (May 31, 1977) [hereafter cited as "Opinion No. 769-A"], JA in No. 77-1496 *et al.* at 394.

base only those advances found "reasonable and appropriate."

The initial advance payment order established Account 166, Advance Payments for Gas, and provided that "advance payments for gas would be recorded as prepayments and unrecovered advance payments would be included in the rate base as part of working capital." [33] Various express conditions limited the advance payments that would be considered for inclusion in rate base. Some of these conditions were modified in the subsequent advance payment orders.[34] Each of the orders stated that

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[33] Order No. 410, *supra* note 4, 44 FPC at 1143.

[34] Order No. 410 encompassed advance payments to independent or affiliated producers for exploration, lease acquisition, development, or production of natural gas, "when such advance payments are to be repaid by delivery of gas." *Id.* at 1146. Advances had to be fully recovered within a "reasonable period of time following commencement of deliveries," and in any case "within a 5-year period." *Id.* The rate base account had to be credited by the amount of non-recoverable advances. *Id.*

Order No. 410-A, *supra* note 4, suspended rate-base treatment for advances to affiliated producers for exploration and lease acquisition costs. 45 FPC 135 (1971). Order No. 441, *supra* note 4, limited the program to the period ending Dec. 31, 1972, and denied rate-base treatment to all advances for exploration and lease acquisition, as well as payments to both affiliated and independent producers which resulted in a working interest. 46 FPC at 1180-81. Where economic interests other than a working interest were received by a pipeline as a result of an advance payment properly includable in the rate base, any realization therefrom was to be treated so as to reduce the pipeline's most of service. *Id.* at 1181. Advance payments might be repaid by delivery of natural gas or by other consideration, and full repayment was required within five years from the date gas deliveries commenced or the date it was determined that recovery would be in other than gas. *Id.* at 1180.

Order No. 465, *supra* note 4, extended the program for one year and reallowed rate-base treatment of advances for exploration while continuing to deny it for lease acquisition costs. 48 FPC at 1554. Advances by a pipeline to an affiliated producer were eligible for rate base treatment, even if the affiliate obtained a working interest. *Id.* at 1154-55. Advances had to be fully repaid within five years of the date deliveries commenced, or the date it was determined that repayment would be in other than gas; and the delivery-commencement or alternative-determination date had to be within five years from the date of the advance. *Id.* at 1153-54. A refund to customers was required if an advance resulted in the finding of proven reserves, gas deliveries commenced, but no gas flowed to the advancing pipelines. *Id.* at 1554.

Order No. 499, *supra* note 4, extended the program for another two years and expanded its coverage to include Alaskan advances made under future contracts (previously only advances in the lower 48 states where eligible for rate base treatment). 50 FPC at 2115. Advances to independent producers resulting in the acquisition of a working interest were permissible, and economic benefits derived from working interest advances need not be credited against the pipeline's cost of service. *Id.* at 2114.

"the Commission plans to consider those amounts recorded in Account 166, Advance Payments for Gas, as rate base items, where found reasonable and appropriate." [35] Thus, properly recording an advance in Account 166 was a necessary, but not a sufficient, condition for inclusion in the rate base. The Commission also had to be satisfied that the advance was "reasonable and appropriate."

There has been no dispute that the advance payments at issue in these cases complied with the express conditions in the pertinent advance payment orders. What is

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[35] Order No. 410, *supra* note 4, 44 FPC at 1144; Order No. 410-A, *supra* note 4, 45 FPC at 135 (by incorporation of Order No. 410); Order No. 441, *supra* note 4, 45 FPC at 1181; Order No. 465, *supra* note 4, 48 FPC at 1555, Order No. 499, *supra* note 4, 50 FPC at 2115.

contested is the Commission's discretion to interpret and administer the "reasonable and appropriate" guideline.

Two orders govern the advance payments in these cases. Order No. 465, issued December 20, 1972, governs advance payment contacts made during 1973. It contains an unelaborated statement of the reasonable and appropriate standard.[36] On December 28, 1973, the Commission issued Order No. 499, which governs advance payment contracts made during 1974-75. In that order, responding to public comments raising the critical timing issue, the Commission emphasized the applicability of the "reasonable and appropriate" standard to that issue. It did not adopt a strict timing rule, but instead stated that as a "general policy" advances must be appropriately expended by the producer within a "reasonable time." [37]

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[36] The Order provided: "Consistent with the amendments to Section 154.63 of the Regulations under the Natural Gas Act adopted herein, the Commission plans to consider those amounts allowed in Account 166, as rate base items, where found reasonable and appropriate." Order No. 465, *supra* note 4, 48 FPC at 1555.

[37] 50 FPC 2111, 2115 (1973):

> [A]s a general policy we shall not consider amounts advanced to be "reasonable and appropriate" for inclusion in rate base where such amounts are in excess of costs for exploration, development and production incurred by the producer within a reasonable time from the date such amounts advanced are included in the pipeline's rate base.

The Commission declined to formulate specific timing standards, determining instead to "examine each advance on a case by case basis." Accounting and Rate Treatment of Advances Included in Account No. 166, Advance for Gas Exploration, Development and Production, Docket No. RM74-4, Order Denying Rehearing of Order No. 499, 51 FPC 818, 819 (1974).

Huge sums in extended front-end advances were transferred to producers under contracts subject to Order No. 465. Despite the Commission's signal in Order No. 499 that it intended to focus on the critical timing requirement, the flood did not abate.[38]

D. *The Administrative Proceedings*

The administrative proceedings commenced with separate filings by petitioners for jurisdictional rate increases pursuant to section 4 of the Natural Gas Act.[39] Each filing was initially suspended, then became effective subject to refund.[40]

In the ensuing hearings the pipelines proposed that all advance payments made during the test period that complied with the express conditions of the relevant ad-

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[38] A report prepared on the basis of Commission files calculated that a total of $5.5 billion had been committed in advance payments as of February 1, 1976. Of that total it would appear that little more than 1% was advanced on a 30-day line-of-credit basis. INGAA Br. in No. 77-1496, *et al.* at 5 n.3; JA in No. 77-1496, *et al.* at 370. Of this total, more than $4.2 billion in front-end advance payments were reportedly committed between August, 1973 and February, 1976. JA in No. 77-1496 *et al.* at 370.

[39] 15 U.S.C. 717c (1976).

[40] Filing by Tennessee Gas Pipeline Co. (No. 77-1496 *et al.*) occurred on June 15, 1973, was accepted and suspended on August 1, and became effective subject to refund on January 1, 1974. JA in No. 77-1496 *et al.* at 321.

Transcontinental Gas Pipeline Corp. (No. 77-1212) made its pertinent filing on July 16, 1974. It was accepted and suspended by the Commission on Aug. 31, 1974, with the rates becoming effective subject to refund on Feb. 1, 1975. JA in No. 77-1712 at 165-66.

Michigan Wisconsin Pipeline Co. (No. 77-1719) filed for its rate increase on November 15, 1974. The rates became effective subject to refund on January 1, 1975. JA in No. 77-1719 at 104.

vance payment order should be included in the rate base. The Commission Staff argued that a reasonable timing element was inherent in the reasonable and appropriate standard and that the payment of advances could only be justified as necessary to provide producers a line of credit for current obligations. The Staff relied on the testimony of Robert H. Benna, who stated in part: [41]

> Based on my experience with Shell, I understand that producers are normally allowed 30 days from the date of billing to pay for contract work and materials. Thus, from the producers' standpoint, receipt of an advance one month prior to the date the related payment is due should allow ample time to pay the bill. The important factor, to the producer, is that he has a commitment by a financially stable pipeline to make advances in amounts and at the time necessary to cover exploration and development costs.

In the Staff's view, an advance was not reasonable and appropriate for inclusion in the rate base unless it was appropriately expended by the producer within 30 days of receipt. It was argued that the pipelines' stockholders, rather than their rate payers, should bear the carrying charges on front-end advances paid more than 30 days prior to their expenditure. Adapting this standard to the test-period methodology employed in rate making, the Staff proposed to disallow inclusion of extended front-end advance payments made during the test period but not appropriately expended within 30 days of its close.[42] The Staff would have allowed an

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[41] JA in No. 77-1712 at 64; JA in No. 77-1719 at 42-43; *see* JA in No. 77-1496 *et al.* at 6-7.

[42] JA in No. 77-1496 *et al.* at 309; JA in No. 77-1712 at 145-46; JA in No. 77-1719 at 108-11. It may be noted that this approach allowed certain advances to be included in rate base even if they were expended more than 30 days after

exception to this rule when it was demonstrated that a financial savings to the rate payer would result from the terms of a particular advance payment contract that outweighed the added cost of deviation from the 30-day rule.[43]

In response, the pipelines submitted extensive evidence of the competitive circumstances obtaining during the period in which the challenged advance payments were made. The pipelines argued that, in this environment, refusal to bid competitively for gas reserves by offering extended front-end advances would have left any hesitant pipeline without gas to meet its commitments, and that such a refusal would have been irresponsible in light of the pipeline's obligations to its customers.[44] Thus, it

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receipt. Though an advance made on the last day of a one year test period would have to have been expended within 30 days to qualify, advances made on the first day of that test period would qualify if expended anytime within the subsequent 13 months. Thus it might be argued that the effective timing reqirement (i.e., the average permissible front-end lag time) was considerably in excess of 30 days.

[43] JA in No. 77-1712 at 145; JA in No. 77-1719 at 116.

[44] *See* Opinion No. 769, Tennessee Gas Pipeline Company, Docket No. RP73-113, Opinion and Order Affirming in Part and Reversing in Part Initial Decision Establishing Just and Reasonable Pipeline Rates (July 9, 1976) (hereafter cited as "Opinion No. 769") (opinion of Commissioner Holloman, dissenting at 2) ("A pipeline such as Tennessee faced with this competitive climate would be remiss in its attempts to attach new supplies of gas on behalf of itself and its customers if it did not use this tool to enter into new gas supply contracts.") JA in No. 77-1496, *et al.* at 359; Opinion No. 769-A, note 32 *supra* (opinion of Commissioner Holloman, dissenting, at 1) ("For the plain fact is this program was thrust upon the pipeline companies, leaving them little choice but to negotiate for these arrangements or abandon the field to competing pipelines. Obviously, considered in the context of growing curtailments and deteriorating gas supply, the

was argued, an advance made in good faith response to competitive conditions was both reasonable and appropriate and should be fully included in the rate base.

The administrative law judges in the proceeding before us, while diverging somewhat in particular results, were congruent with each other in critical aspects.[45]

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latter course would have evidenced a willful disregard of Tennessee's responsibilities to its customers bordering on negligence."), JA in No. 77-1496 *et al.* at 406.

[45] Tennessee sought inclusion in rate base of nearly $197 million in advance payments to domestic producers, all governed by Order No. 465. JA in No. 77-1496 *et al.* at 313. The administrative law judge rejected Staff's 30-day rule as "unduly restricted and arbitrary." *Id.* at 311. In general, the pipeline's unchallenged good faith and business judgment was found to qualify advances as reasonable and appropriate. *Id.* at 310-11. However, the ALJ perceived an important difference with respect to $59 million of the total, comprising advances to affiliated producers. He found that these advances did not constitute an "arm's length transaction" since the unearmarked affiliate funds were advanced near the close of the test period and were available for uses unrelated to gas development. Approximately $28 million in unexpended intracorporate domestic advances were excluded from rate base. *Id.* at 314-15.

Transco's advances, totaling approximately $15 million, were governed in part by Order No. 465 and in part by Order No. 499. The pipelines' business judgment rule was accepted with respect to the Order No. 465 advances. JA in No. 77-1712 at 147. However, the ALJ viewed the articulation in Order No. 499 of a reasonable timing requirement as a sharp change in Commission policy. All Order No. 499 advances not expended at the close of the test period were excluded from rate base. *Id.* at 152-54.

Approximately $11.5 million in advance payments, governed by Order No. 499, are involved in the Michigan-Wisconsin proceeding. The ALJ found that all the front-end advances, including those made to an affiliated producer, satisfied the reasonable timing requirement even though they did not comply with Staff's 30-day rule. JA in No. 77-1719 at 112-14.

Each was receptive to the competitive conditions justification proffered by the pipelines. Each perceived the express mention in Order No. 499 of the timing requirement as a shift in Commission policy. By and large, each rejected the Staff's 30-day rule.

The Commission overruled the initial decisions, adopting the Staff's position that a reasonable timing requirement was inherent in the reasonable and appropriate standard of both Order No. 465 and Order No. 499. In its view, the advance payment program was designed to benefit rate payers by providing capital to finance exploration and development of additional gas supplies and to expedite development of existing reserves. It was not intended to provide a license for pipelines to bid against each other for available gas. The Commission concluded that there was no inherent justification in terms of the purposes of the program for advances made prior to the time they were reasonably required to facilitate qualifying producer expenditures. While these extended front-end advances provided a benefit to producers, no public service benefit could be discerned. In the Commission's view, only one consideration was relevant in determining whether a timing relationship satisfied the reasonable and appropriate standard: the financial requirements of the transaction, *i.e.*, the lag time required to allow a smooth transfer and expenditure of funds. The Commission regarded the Staff's 30-day line-of-credit rule as a well-pleaded presumption, subject to rebuttal, as to producer needs and pipeline abilities. Since there had been no showing by the pipelines that producers required funds more than 30 days prior to appropriate expenditure, nor that pipelines needed more time to finance advances, the Staff's rule was applied to determine inclusion in the rate base.[46] The Commission

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[46] Opinion No. 769, *supra* note 44, at 29-34, JA in No. 77-1496, *et al.*, at 348-51; Opinion No. 769-A, *supra* note 32, at

stated: [47]

> [W]hile we do not find that a maximum time lag of thirty days between advance and expenditure is necessarily the only reasonable and appropriate standard, it was well pleaded and completely unrebutted. . . .

The Commission adopted the Staff's proposal that any advances failing to satisfy the 30-day test would be included in rate base only if the terms of the particular advance payment contract would "save the ratepayer more in advance payment carrying charges than would be saved by insisting upon Staff's 30 day installment rule." [48] The Commission did not consider that its express reference to the timing requirement in Order No. 499 represented a dramatic shift in policy from its earlier orders. Rather, the reference merely highlighted

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4-10, JA in No. 77-1496 *et al.* at 395-401; Opinion No. 801 Transcontinental Gas Pipe Line Corp., Docket Nos. RP74-48 & RP75-3, Opinion and Order Affirming in Part and Reversing Initial Decision on Reserved Issues and Establishing Just and Reasonable Pipeline Rates 21-23 (May 31, 1977) [hereafter cited as "Opinion No. 801"], JA in No. 77-1212 at 185-87; Michigan Wisconsin Pipe Line Co., Docket No. CP70-22, *et al.*, Order Reversing Initial Decision 2-4 (June 3, 1977) [hereafter cited as "Michigan-Wisconsin Order"], JA in No. 77-1719 at 116-20. The Commission declined to differentiate between advances to affiliated and to non-affiliated producers, thus differing from the reasoning of the ALJ in the Tennessee proceeding. But the same result was achieved—exclusion of unexpended intracorporate advances from the rate base—on the basis of the 30-day standard.

[47] Opinion No. 769-A, *supra* note 32, at 5, JA in No. 77-1496, *et al.* at 396; Michigan-Wisconsin Order, *supra* note 46, at 4, JA in No. 77-1719 at 119.

[48] Opinion No. 801, *supra* note 46, at 22, JA in No. 77-1712 at 186; *see* Opinion No. 769, *supra* note 44, at 32, JA in No. 77-1496, *et al.* at 351; Michigan-Wisconsin Order, *supra* note 46 at 3, JA in No. 77-1719 at 118.

one element of the reasonable and appropriate standard. Thus, the same criteria were applied to both Order No. 465 and Order No. 499 advances.

The net effect of the Commission's advance payment determinations was the temporary exclusion from the rate base of advances not satisfying the timing requirement. It is important to note that this was a deferral, not a disqualification. Subsequent filings for rate increases would entail new test periods; ultimately, when the expenditure was in fact made during a test period or within 30 days after its close, the deferred advances would be included in the appropriate rate base. This deferral aspect must be distinguished from outright disqualification resulting when advances failed to satisfy one or more of the express conditions stated in the advance payment orders. Nevertheless, substantial sums were involved and deferral has resulted in considerable losses for the pipelines' stockholders.

E. *Interpretation of the Advance Payment Orders*

The pipelines assert that the advance payment orders contemplated the use of extended front-end advance payments as a mode of competition for available supplies of gas. From this it is argued that the Commission's current interpretation constitutes retroactive rule making. The pipelines rely principally on various excerpts from the text of the orders, and draw additional support from language in previous administrative decisions. Moreover, it is asserted that to the extent the Commission's current interpretation might at one time have been a reasonable and legally supportable construction, that approach has been foreclosed by the Commission's repeated renewal of the program without appropriate modification in the face of actual and constructive notice that extended front-end advances had become a term of trade. The express mention of a reasonable timing standard in

Order No. 499 is viewed as an inadequate reaction to a crying need. Indeed, the generality of the Commission's response to specific comments is cast as further evidence that the Commission did not intend at the time to curtail extended front-end advances. Finally, as to the Commission's use of Staff's 30-day rule as a presumption subject to rebuttal, petitioners challenge its evidentiary basis, and more fundamentally its premise that the only factor relevant to application of the reasonable and appropriate standard was the financial requirements of the transaction.

The essence of petitioner's arguments is this: multiple factors encouraged extended front-end advances, and no specific Commission direction restricted their use. Asserting that each pipeline's good faith business judgment should prevail over the Commission's present interpretation, petitioners propose this clear-cut rule: "the sole test for determining whether the advance payments made under these orders were to be included in rate base as 'reasonable and appropriate' [should have been] whether they were made in order to obtain commitments for additional gas supplies." [49]

We find that petitioners' arguments in support of their interpretation are undercut by consideration of the character of the advance payment program as an experimental departure from well accepted and understood principles of regulatory law. The Commission has correctly construed the underlying purposes of the program as it was understood by this court in *PSC (Advance Payments) I & II* and has not abused its discretion in discerning a reasonable timing requirement and in rejecting petitioners' "business judgment rule" as the "sole

[49] Tennessee Br. in No. 77-1496, *et al.* at 15 (emphasis deleted).

test" for the program's administration.[50] Completely separate, however, is the question whether the Commission, in choosing a manner of administering the reasonable timing requirement, gave due consideration to all pertinent factors. As discussed in section I-F *infra*, we conclude that it did not, and remand. But first we turn to those considerations that support rejection of petitioners' business judgment rule.

1. *Petitioners have the burden of demonstrating an affirmative authorization for extended front-end advances.* In *Smyth v. Ames*,[51] the Supreme Court articulated the guiding principle that "the basis of all calculations as to the reasonableness of rates to be charged by a [public utility] must be the fair value of the property *being used by it for the convenience of the public.*" Although methods for determining values of rate base items have evolved since *Smyth v. Ames*,[52] the precept endures that an item may be included in a rate base only when it is

[50] Although we employ the term "business judgment rule" to characterize the pipelines' suggested approach, we do not intend to import the extensive jurisprudence that has developed in connection with use of the term as a standard for measuring the duty of corporate directors and other fiduciaries.

[51] 169 U.S. 466, 546 (1898) (emphasis supplied).

[52] *See* FPC v. Hope National Gas Co., 320 U.S. 591, 605 (1944); FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 599-608 (1942) (concurring opinion of Black, Douglas and Murphy, JJ.); Driscoll v. Edison Light & Power Co., 307 U.S. 104, 122-24 (1939) (Frankfurter, J., concurring); McCart v. Indianapolis Water Co., 302 U.S. 419, 423-41 (1938) (Black, J., dissenting); Missouri *ex rel.* Southwestern Bell Tel. Co. v. Public Service Com'n., 262 U.S. 276, 289-312 (1923) (opinion of Brandeis, J.); City of Detroit v. Panhandle Eastern Pipe Line Co., 3 FPC 273, 278-80 (1942); Chicago District Electric Generating Corp., 2 FPC 412, 416-20 (1941).

"used and useful" in providing service. In other words, current rate payers should bear only legitimate costs of providing service to them. The FPC early adopted the "used and useful" standard and has not departed from it without careful consideration of the wisdom of requiring current rate payers to bear costs of providing future service.[53]

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[53] *E.g.*, Mississippi River Fuel Corp., 4 FPC 340, 344 (1945) ("It has been the general practice of this Commission to determine the rate base by ascertaining the net investment in the gas plant used and useful in rendering service, and adding a reasonable allowance for working capital."); Chicago District Electric Generating Corp., 2 FPC 412, 420 (1941). The "used and useful" standard was expressly incorporated into the depreciation provisions of section 9 of the Natural Gas Act, 15 U.S.C. § 717h (1976), which provide in part: "The Commission may from time to time ascertain and determine, and by order fix, the proper and adequate rates of depreciation and amortization of the several classes of property of each natural-gas company used and useful in the production, transportation or sale of natural gas."

Compare Cities Service Gas Co., 3 FPC 459, 490 (1943) ("While a strict interpretation of rate making principles might require no allowance for return and depreciation on the Hugoton [pipeline] project until it is completed and in service, we believe that, because of the urgent necessity for relieving the gas transportation shortage during the war emergency, it is in the public interest presently to make such an allowance in connection with the interim reduction of rates ordered in this proceeding."); General Policy and Interpretations, Inclusion of Construction Work in Progress in Rate Base, 41 Fed. Reg. 51392, 51393 (1976) ("The question of the proper treatment for ratemaking purposes of capital expenditures which have not yet been placed in service is one which is subject to a play of conflicting principles. On the one hand, public utility regulation has generally adhered to the principle that a rate base should only include items which are 'used and useful.' On the other hand, regulation has also always recognized that the expense of financing construction to serve customers is itself a legitimate expense which must ultimately be borne by the ratepayers."); Order

One such departure was the advance payment program. At the very least it contemplated that current rate payers would shoulder the costs (*i.e.*, the financing charges) of qualifying advance payments. This was intended to expedite the development of additional gas reserves by providing supplemental sources of capital, which would be used to provide service for future rate payers. Such a modification of the "used and useful" principle was thought justified in view of the discouraging supply forecasts and the general correspondence between classes of current and future rate payers. Consumers would eventually have to bear the costs of developing needed gas supplies. In theory, the advance payment program promised to provide that gas at the lowest ultimate cost.[54]

The Commission has taken the position that any departure from such a well-rooted regulatory principle must be affirmatively authorized and that an authorized departure must be presumed limited to its express terms. We agree with the analysis that agency silence in these circumstances must be construed to mean that traditional principles retain their vitality.[55] We are not so clear that authorization for a departure from settled principles must be expressly set forth in an order (as contrasted with what is fairly discernible as the intent

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No. 566, Changes in Accounting and Rate Treatment for Research, Development and Demonstration Expenditures, Docket No. RM76-12 (June 3, 1977). Regulations permitting rate-base treatment of R & D expenditures, with certain qualifications, are codified at 18 CFR 201(103) (1978).

[54] *PSC (Advance Payments) I*, *supra* note 3, 151 U.S.App. D.C. at 316, 467 F.2d at 370.

[55] *See* NLRB v. Majestic Weaving Co., 355 F.2d 854, 860 (2d Cir. 1966); NLRB v. International Bhd. of Teamsters, 225 F.2d 343, 348 (8th Cir. 1955). *See* Standard Oil Co. v. Dept. of Energy, No. 6-13, slip op. at 20-56 (Temp. Emer. Ct. App. 12/13/78) (reaching a different result where there existed no previously well-settled rule).

of an order), but it must be established with reference to the order.

This conclusion allows us to by-pass petitioners' factual assertions that, during the pendency of the program, the Commission had actual and constructive notice that it was widely understood within the industry to be acquiescing in extended front-end advances. It is urged that the Commission's failure expressly to restrict extended front-end advances gave such payments an affirmative blessing, or—what is the same thing—estops the Commission from now asserting an interpretation contrary to that held by the pipelines. We accept *arguendo* petitioners' factual assertions of notice, and reject their proffered conclusion. Though a belief that the agency was cognizant of widespread employment of extended front-end advances may have further encouraged their use, the Commission's inaction cannot be construed to change existing law where the Commission resists such a change and has given no indication that it intended a wholesale abandonment of traditional principles. Any modification of traditional principles broad enough to permit extended front-end advances must be derived from the advance payment orders themselves, not from Commission inaction. Further, since the Commission relies on well-established principles of public utility law, it is not sufficient for petitioners to come forward with some conceivable interpretation of language in the advance payment orders that supports their view. At the very least, the burden must fall on petitioners to demonstrate that a preponderance of the interpretative evidence is favorable to their position.

2. *The program was intended to provide additional sources of capital to expedite development of gas supplies, not to give license for competition among pipelines.* Petitioners attempt to carry their burden of showing an affirmative authorization for extended front-end advances

by citing specialized provisions of the advance payment orders, which they construe to support their position. The first problem is that the cited passages, often less than clear, are subject to conflicting interpretations.[56] But a more fundamental difficulty with petitioners' approach is the premise that the underlying purposes of the program

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[56] For example, petitioners place substantial reliance on the statement in Order No. 441, *supra* note 4, that: "Advances may be recorded in Account 166 and *shall* be included in rate base where such payments are reasonable, necessary and appropriate in order to contract for gas supplies by agreement executed not later than December 31, 1972." 46 FPC at 1180 (emphasis supplied). Petitioners focus our attention on the facially directory langauge. It may be noted first that following this statement, the order iterates, "the Commission plans to consider those amounts recorded in Account 166, Advance Payments for Gas, as rate base items, where found reasonable and appropriate." *Id.* at 1181. An harmonious construction of these two sentences is that need "to contract for gas supplies" is a necessary, but not a sufficient condition for inclusion in rate base. We may note secondly that the key ingredient added to the order by the relied-upon sentence is specification of the order's termination date as December 31, 1972. Concentration on the sentence's primary purpose may have caused the Commission to overlook careless drafting. Insofar as petitioners' argument is premised on a justifiable reliance on the directory language, it is undercut by the Commission's paraphrase of the critical sentence in the Order of Clarification and Denial of Rehearing or Modification, 47 FPC 57, 58 (1972):

> Tennessee is uncertain as to whether a return will be allowed on the unamortized balances of non-recoverable advances. It is our stated position in the fourth paragraph of page 1180 of Order No. 441, that advances recorded in Account 166 *may* be included in rate base where such payments are reasonable, necessary and appropriate in order to contract for gas supplies by agreement executed not later than December 31, 1972. There is no provision for the inclusion in rate base of amounts that must be eliminated from Account 166.

(Emphasis supplied.)

were sufficiently ambiguous to admit of an interpretation favorable to extended front-end advances. We find overwhelming the Commission's evidence as to the purposes of the program, as intended by the Commission and as understood by this court in *PSC (Advanced Payments) I*. Thus we need not pause to consider in depth the particulars of petitioners' references (and the Commission's strenuous rebuttals) but may proceed to consider the evidence supporting the Commission's narrower view.

In the introductory paragraphs to Order No. 441, the advance payment order conditionally approved in *PSC (Advance Payments) I*, the Commission stated: [57]

> In our area rate opinions for *Southern Louisiana* and *Texas Gulf Coast* (Opinion Nos. 598, 46 FPC 86, and 595, 45 FPC 674), we recognized that it is the function of a just and reasonable rate for independent producers to elicit requisite gas supply, and that costs, in economic terms, reflects the required level of capital formation to elicit that level. In other words, the just and reasonable area rate in these recent opinions did not consider "non-cost" items. Having acknowledged, as we do, that provisions for special rate treatment of advance payments by pipelines have been justified in the past on the basis of providing additional incentives in this experimental undertaking, we nevertheless seek to avoid separate, non-price incentives as much as possible.
>
> A critical shortage of gas exists in the United States; capital formation for gas development is difficult. The objectives of providing capital to accelerate the addition of new gas supplies supports our continuation for the limited period of the rate treatment of advance payments provided herein. We recognize that the just and reasonable area rates

[57] Order No. 441, *supra* note 4, 46 FPC at 1179-80.

> for independent producers will hopefully alleviate this gas supply shortage over the long-run; however, for the immediate term, (namely through 1972) our advance payments policy has been designed to increase directly the funds available for the necessary exploration and developmental effort. It is our intention that rate base treatments for advances included in Account 166 be terminated for advances resulting from contracts executed after December 31, 1972, unless otherwise ordered.

The Commission's starting point was its recognition of the role of just and reasonable area rates for producers in "elicit[ing] requisite gas supply." For the long-run, the articulated policy was to incorporate in the certificated rate all required incentives to assure requisite supply; "non-price incentives" were to be avoided "as much as possible." Contrary to this long-term policy, advance payments embodied a "non-price incentive" in the "bonus" inherent in the interest-free loan of capital. Nevertheless, since the Commission recognized that a "critical shortage of gas exist[ed]" and "capital formation for gas development was difficult," the "objective of providing capital to accelerate the addition of new gas supplies" justified continuation "for the immediate term" of a policy "designed to increase directly the funds available for the necessary exploration and developmental effort." It was apparent on the face of the order that the purpose of an advance payment was to provide "reasonable and appropriate" developmental capital for "qualifying expenditures." Yet, the pipelines argue that the orders approved all extended front-end advances, contary to the Commission's view that for the extended period between receipt and expenditure many of these advances made no such contribution of developmental capital while providing producers with a non-price incentive of the type the program explicitly sought to avoid "as much as possible." In the face of such a clear ex-

pression of limited purpose, we find untenable the argument of the pipelines for carte blanche authority to make advances.

One of petitioners' arguments that figures prominently in any defense of the pipelines' behavior asserts that the advance payment program contemplated competition among pipelines for available gas through the use of extended front-end advance payments, which would effectively raise the price of natural gas and thus inevitably contribute, in an indirect way, to the alleviation of the natural gas shortage. The fatal weakness in this argument is that it confuses an incentive with a justification. Certainly the Commission contemplated that the prospect of obtaining additional gas reserves for an individual gas distribution system would encourage a pipeline to offer advance payments.[58] But the mere fact that an advance payment made good business sense to the advancing pipeline was not alone sufficient to authorize its use. Advance payments were not an end in themselves. They were legitimate only insofar as and to the extent that they provided producers with a source of developmental capital for use in qualifying expenditures. In the passage from Order No. 441 quoted above, the stimulating effect on gas supply of the price-incentive aspect of advance payments was expressly *excluded* by the Commission as an objective of the advance payment program; rather, the price-incentive aspect was tolerated as a necessary and subsidiary adjunct to the capital-formation objective.

The conclusion that the Commission had no intention of encouraging internecine bidding among gas-starved pipelines is fortified by the pervasive tone of the advance payment orders, exemplified by the above-quoted passage, that the overall goal in both the long-run and the

[58] *See* note 8 *supra*.

immediate-term was to elicit requisite gas supply for the nation *as a whole*, not for any particular pipeline system at the expense of others.

In another provision of Order No. 441, the Commission showed a particularized concern that advances should not be used for competitive purposes but rather should be cost-justified in terms of the consumer benefit derived from furtherance of the program's objectives:[59]

> Our review of the various comments and available data has persuaded us that advances for exploration and lease acquisition have not [been] shown to be an effective vehicle *for stimulating the widespread participation in natural gas production for which their encouragement was intended.* Moreover, there is some indication that the availability of advances for such purposes by creating competition among pipelines to make such advances may be having the effect of increasing the amounts expended on lease acquisition without a proportionate improvement in gas supply.

The Commission excluded from the category of "qualifying expenditures" advance payments for exploration and lease acquisition since they could be identified as an entire category that did not further the justifying objectives of the program, but were instead fostering undesirable competition among pipelines without an offsetting consumer benefit. When this court affirmed the program in *PSC (Advanced Payments) I*, we highlighted this adjustment as an example of the Commission's flexibility and willingness to modify the program, which we considered a prerequisite to sound administration.[60]

[59] Order No. 441, *supra* note 4, 46 FPC at 1180 (emphasis supplied).

[60] *PSC (Advance Payments) I*, *supra* note 3, 151 U.S.App. D.C. at 313, 467 F.2d at 367.

In *PSC (Advance Payments) I*, we unambiguously understood the program's objective to be the creation of an additional source of capital to facilitate the natural gas development and production necessary to alleviate the gas shortage. In one illustrative passage, we noted:[61]

> The rationale behind this decision is that the advance payments will help to give the gas producers the necessary investment capital to finance the development and production needed to alleviate the gas shortage, and the pipelines will be encouraged to make such advance payments if they are allowed to include the payments in their rate base, thus virtually simultaneously shifting the cost of the advance payments to the pipelines' customers, the natural gas consumers.

There was no hint in *PSC (Advance Payments) I* that a justifying objective of the program was the encouragement of competition among pipelines for scarce supplies of gas. On the contrary, by consistently referring to "producers," "pipelines" and "consumers" throughout the opinion, we evidenced our conviction that the revelant interests were nationwide in scope, not those of any particular pipeline or its customers.

It is a crucial aspect of this case, refuting the pipelines' basic retroactive rule making contention, that the limited purposes of the advance payment program were unambiguously articulated, in both Order No. 441 and in the affirming opinion of this court, well prior to the date of any advance payment contract involved in these cases.

In *PSC (Advance Payments) I* we had made clear that continued approval of the program was dependent on the Commission's ongoing modification and evaluation to assure that the program was accomplishing its ultimate purposes—alleviation of the gas shortage—at an acceptable cost to the natural gas consumer. This process was undertaken in both Order No. 465 and Order No. 499. In the opening sentence of each, the Commission stated that the focus of its inquiry was "to determine whether the advance payment program [was] stimulating activity toward increasing the supply of natural gas sufficiently to justify the extension of rate base treatment of advances."[62] In Order No. 465 the Commission concluded: "in view of our analysis of all the responses . . . and our review of the program of advances in general, we find that rate base treatment of advances to producers has 'represented a justifiable experiment in the continuing search for solutions to our nation's critical shortage of natural gas.'" [Quoting from *PSC (Advance Payments) I*][63] In Order No. 499 the Commission stated: "review of the data . . . indicates that the advance payment program has continued to meet its objectives of bringing additional gas supplies into the interstate market at an acceptable cost to the nation's gas consumers," and "that pipeline advances have continued to accelerate the capital formation which led to the exploration, development and dedication of 10.27 Tcf of proven reserves of natural gas as well as 9.57 Tcf of potential reserves of natural gas to the interstate market."[64] Neither Order No. 465 nor Order No. 499 severed the tie between the objective of capital formation and the authorized use of advance payments. Each Order continued to assess the program in terms of nationwide gas supply, not improvement for some pipeline systems at the

[61] *Id.* at 309, 467 F.2d at 363. *See also id.* at 317, 467 F.2d at 371 (on petition for rehearing).

[62] Order No. 465, *supra* note 4, 48 FPC at 1550; Order No. 499, *supra* note 4, 50 FPC at 2111.

[63] 48 FPC at 1553.

[64] 50 FPC at 2112-13.

expense of others. Again, there was direct evidence that competition among pipelines was not a desirable nor intended effect of the program.[65] Although we found the Commission's review of the data inadequate in *PSC (Advance Payments) II*, we found no inconsistency of purpose in the Commission's orders and reiterated our understanding of the program as expressed in *PSC (Advance Payments) I* and in the previous orders.[66]

The Commission consistently referred to the purpose of capital formation to accelerate improvement in overall gas supply as the purpose of the program and never put forward the purpose of facilitating for its own sake the enhancement of producer prices through competition among pipelines for available gas supplies. Had the Commission advocated such an objective, we discern no basis on which we would have approved it as permissible under the Natural Gas Act.

3. *Leyal infirmity of a program approving all front-end advances.* The Natural Gas Act requires the Commission to anchor its regulation of producers in the maintenance of just and reasonable rates. In *Texaco*,[67] which issued at a time when the strain of natural gas shortage

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[65] In Order No. 465, *supra* note 4, the Commission stated:

> It is clear then that advances for exploration and lease acquisition have resulted in significant production activity. However, the comments indicate that advances for lease acquisition may have been a contributing factor in bidding up of the price of leases. Therefore we shall henceforth allow advances for exploration in rate base while continuing to exclude advances for lease acquisition from rate base.

48 FPC at 1554 (1972).

[66] *PSC (Advance Payments) II*, *supra* note 3, 167 U.S.App. D.C. at 103-04, 111-13, 511 F.2d at 341-42, 349-51.

[67] FPC v. Texaco Inc., 417 U.S. 380 (1974).

was acute, the Supreme Court held that the Commission had acted impermissibly in exempting small producers from direct rate regulation and rejected as inadequate the Commission's contention that it was sufficient to regulate small producers indirectly, by reason of the consequences of regulation of pipelines and of large producers. Indirect regulation was permissible, but only when and if the Commission developed safeguards to ensure that the rates paid by pipelines, and ultimately borne by consumers, remained just and reasonable.[68]

In *Consumer Federation of America v. FPC*,[69] we disapproved a program in which the Commission attempted to authorize competitive bidding for needed gas supplies by pipelines experiencing critical short-term supply difficulties. That program granted producers 180-day exemptions from rate limitations and permitted them to enter into contracts with eligible pipelines without risk of refund. The order provided that gas costs "shown to have been required by the public interest" were to be passed on to consumers.[70] We invalidated the program, even though it was proffered as an experiment responding to a supply crisis, since it failed to provide adequate assurance that just and reasonable rates would be maintained. We concluded:[71]

> [T]he Commission has exceeded its authority under the Act. In essence, it has attempted to remedy the shortfall of supply in the interstate market by au-

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[68] *Id.* at 401.

[69] 169 U.S.App.D.C. 116, 515 F.2d 347 (1975).

[70] Order No. 491-B, 50 FPC 1463, 1470 (1973). The program reviewed in *Consumer Federation* was governed by Order No. 491, 50 FPC 742 (1973); Order No. 491-A, 50 FPC 848 (1973); Order No. 491-B, *supra;* and Order No. 491-C, 50 FPC 1634 (1973).

[71] 169 U.S.App.D.C. at 129, 515 F.2d at 360, *quoting PSC (Advance Payments) I*, *supra* note 3, 167 U.S.App.D.C. at 116, 511 F.2d at 354.

> thorizing a supplemental injection of large quantities of gas through sales freed from the constraints of meaningful regulation. We reject the FPC's claim that § 7(c) [of the National Gas Act] supports this substantial, partial deregulation, and find that the Commission has neglected its rate control responsibilities under the Act. Congress has yet to embrace proposals for deregulation of new gas supplies. Until it acts to alter the present "system of regulation by an agency subject to court review, the courts may not abandon their responsibility by acquiescing in a charade or a rubber stamping of non-regulation in agency trappings."

To adopt petitioners' contention, which would validate any "timing" arrangement that a pipeline found justified as a matter of business judgment were it to compete successfully for gas supply in a shortage crisis, would be nothing more nor less than acceptance of a deregulatory approach, a ruling that cannot be reconciled with the teaching of *Texaco* and *Consumer Federation*. A producer receiving an extended front-end advance, to use without restriction for a significant period prior to expenditure, is in effect given a sum of money. There is no meaningful distinction between receipt of unrestricted funds for a period and receipt of a sum equivalent to the "return" (at a minimum, interest) procurable from use of the funds. In both circumstances producers will be compensated in excess of certificated rates. The business-judgment rule would permit pure competitive bidding by pipelines using the device of extended front-end advance payments.

Had the Commission articulated the approach now advanced by the petitioners as an interpretation, we would have disapproved it as an abdication of the agency's regulatory responsibilities. This is not to say that the deployment of funds must be instantaneous. What is

inappropriate is unrestricted transfer for more than a reasonable period—a concept to which we shall return.

Any permission to transfer advances prior to gas delivery (even as to funds used immediately or in a reasonable time for qualifying developmental expenditures) entailed some variance from the previous situation, in terms of benefit to producer and of cost to pipeline and customer. However, the ultimate cost to the consumer was projected to remain within the just and reasonable range because of the compensating benefit of expedited gas development, and the maintenance of restrictions relating the cost to the benefit.[72] This justification, and these safeguards, were lacking as to the extended front-end advances made without restriction other than the competitive "business-judgment rule."

4. *Claim of retroactive rule making.* The foregoing analysis undercuts petitioners' contention that a reasonable timing requirement amounted to retroactive rule making. The pipelines had fair notice both of traditional regulatory principles and that the advance payment program exception was put forward and affirmed on a basis that did not encompass the departure asserted by petitioners.

In *Natural Gas Pipeline Co. v. FERC*,[73] the Seventh Circuit recently ruled that the Commission's interpretation of the reasonable and appropriate standard to impose a relatively inflexible "30-day rule" constituted im-

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[72] These restrictions include the maximum allowable payback period (*see* note 34 *supra*), economic motivations for producers to proceed expeditiously with development once advances have been "sunk" in qualifying expenditures, and the continued supervision of all aspects of timing and amount of advance payments under the reasonable and appropriate standard.

[73] 590 F.2d 664 (7th Cir. 1979).

permissible retroactive rule making. It viewed the case as falling within a doctrine, articulated in *Bell Aerospace Co. v. NLRB*,[74] whereby an agency's broad discretion to announce policy in adjudication is subject to an exception in a case of severe impact and justifiable reliance on contrary agency pronouncements.[75] It stated:[76]

> The consequences to the appellant of denying rate base treatment to the advances are very severe. It would mean the imposition of a large liability with regard to the advances in the present case. Furthermore, the appellant's entering into these agreements, under these terms, was in reliance upon the prior orders of the Commission, and the policies reflected in those orders, specifically the policies encouraging the advance payment program, with few restrictions, and the promulgation of a flexible standard with regard to the advance-expenditure time relationship. We believe that the aforementioned facts require that the Commission's discretion to proceed by adjudication as opposed to by rulemaking be restricted so as to prevent the imposition of a "30 day rule" in this proceeding.

We differ from the Seventh Circuit in that, in our appraisal, the Commission's current interpretation of the limited purpose of the advance payment orders does not reverse a policy that had been the subject of reasonable reliance.

The Commission's rulings on appeal are rooted in basic principles of regulation and in petitioners' notice of the limited purpose of the advance payment exception. We do

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[74] 416 U.S. 267 (1974).

[75] *Id.* at 295.

[76] 590 F.2d at 669.

not discern the substantial claim of justifiable reliance that is needed to invoke the *Bell Aerospace* exceptions.[77]

In support of its ruling the Seventh Circuit cited our decision in *Consumer Federation*:[78]

> While the factual pattern of *Consumer Federation of America, supra*, is not identical to the present case, the opinion does demonstrate an effort being made to protect the pipeline companies from the squeeze which results if the pipeline incurs expenses for emergency gas which is not refundable. A very similar type of problem to that discussed in *Consumer Federation of America, supra*, is present in this case. Through Order No. 499, and the four previous orders, the Commission encouraged a program of advances by interstate pipelines to producers to secure commitments of natural gas. Furth-

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[77] The limitations on permissible retroactivity may be discerned from SEC v. Chenery Corp., 332 U.S. 194 (1947), and NLRB v. Majestic Weaving Co., 355 F.2d 854 (2d Cir. 1966) (Friendly, J.). The relevant factors include the degree of retroactivity, the need for administrative flexibility, and the hardship on the affected parties. With respect to advance payments, the Commission has not changed an explicit past policy *(Majestic Weaving)* but rather has reaffirmed well-established regulatory principles. The need for flexibility is evident in a case, such as this, where "the agency may not have had sufficient experience with a particular problem to warrant rigidifying its tentative judgment into a hard and fast rule." *Chenery*, 332 U.S. at 202. The Commission specifically noted the need for a case-by-case determination of the timing question. *See* note 37 *supra*. Hardship to the pipelines is mitigated by two factors. First, the Commission merely has deferred rate-base treatment, not forever disqualified extended front-end advances from inclusion in rate base. Second, even during the deferral period, the pipelines have the assurance that their rates will remain at compensatory levels. FPC v. Texaco, 417 U.S. 380, 391-92 (1974); FPC v. Natural Gas Pipeline Co., 315 U.S. 575, 585 (1942).

[78] 590 F.2d at 670.

> ermore, inherent within the Commission's orders was an attitude of experimentation and flexibility as reflected in the "reasonable time" standard which the Commission chose to include in Order No. 499. Nevertheless, in electing to utilize a "reasonable time" standard, by itself, the Commission failed to furnish the pipelines with any sort of guidelines which might be followed in contracting with producers for commitments of gas reserves. Then after the agreements are entered into and the advances made, the Commission wants a "reasonable time" to be defined as "30 days", with the obvious effect of such action being that the pipeline would be forced to absorb huge costs which are not capable of being reflected in its rate base. To follow the course set forth by the Commission would be to contravene the policy expressed by the court in *Consumer Federation of America, supra.*

The Seventh Circuit's citation of our opinion in *Consumers Federation* is a subsidiary point in its approach, dependent on its major premise of justified reliance. In any event, we did not intend *Consumers Federation* to express a general solicitude for all pipelines caught in a "squeeze" to obtain gas. In that case there was a wholesale deregulation of producers, and we found that the indefinite indication that pipelines would be held to a "public interest" limit on prices paid was not enough to assure maintenance of just and reasonable rates. In the present case, there was a continuing regulation, not a deregulation, and the advance payment order that was judicially approved articulated a reasonable and appropriate standard which the Commission, and this court, find was not discarded, as to the matter of timing of payments, in favor of a competitive business judgment rule.

While we differ from the Seventh Circuit both on the issue of justifiable reliance and on the meaning of *Consumers Federation*, we agree with that court in its dis-

approval of the Commission's relatively rigid "30-day rule." We concur in its view that "inherent within the Commission's orders was an attitude of experimentation and flexibility,"[79] which in turn involves flexibility in administration. We develop our views in the next section of this opinion, but interpolate at this point that the remand which we order can be implemented by the Commission with results that do not violate the remand by the Seventh Circuit.

F. *Improper FERC Administration of the Advance Payment Program*

We have concluded that the Commission acted within its discretion in rejecting both the pipelines' interpretation of the advance payment orders and their proposed competitive business judgment rule for administration of the "reasonable and appropriate" standard. We now turn to a consideration of the Commission's administration of the "reasonable timing requirement," which in light of the program's justifying objectives was implicit in the reasonable and appropriate standard.

We recognize the limited scope of our review function. Although a court may not supplant the Commission's well-reasoned judgments with those more nearly to its liking, it must assure itself that "the Commission has given reasoned consideration to each of the pertinent factors." *Permian Basin Area Rate Cases*, 390 U.S. 747, 792 (1968).

1. *Defining the reasonable timing requirement.* In evaluating the timing relationship between an advance payment and its qualifying expenditure, the Commission focused solely on the timing requirements of conventional financing transactions.[80] It relied on the testimony of its

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[79] *Id.*

[80] *See* text accompanying note 46 *supra.*

staff engineer Robert H. Benna set forth earlier in this opinion.[81] His testimony, based on his earlier employment by Shell, was submitted as evidence that producers could satisfactorily arrange for payment of contract and materials costs on the basis of a continuing commitment and specific payments thirty days in advance of due date. From this the Commission evolved a 30-day line-of-credit approach, which it established as a presumption subject to rebuttal. It found that in the cases before it the rule was unrebutted by evidence of financial inability on the part of either producer or pipeline to arrange for payments due under advance payment contracts to be transferred on a line-of-credit basis. We find the Commission's approach unduly restrictive in that it failed to take account of all factors relevant to the "reasonable timing" inquiry.

We agree with the Commission that its advance payment orders do not imply either a competitive business judgment rule as the sole standard for timing of advances, or authority for the extravagant costs of extended front-end advances not accompanied by reasonable controls on the timing of expenditures. However this does not mean that its orders disclosed a requirement that the pipelines adopt the "tight" timing practices of conventional financing transactions employed by producers like Shell in their arrangements with contractors. No strict line-of-credit requirement could fairly be implied from the terms of the advance payment orders. By so restricting the scope of its "reasonable timing" inquiry, the Commission failed to evaluate fully and fairly the reasonableness of the protective mechanisms adopted by particular pipelines to fulfill their obligation of vigilance in the consumers' interest.[82]

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[81] *See* text accompanying note 41 *supra*.

[82] Had the Commission considered all pertinent factors, we would not lightly overturn its result merely because of severe

The advance payment program was accepted by all concerned as an experimental and unconventional method of financing producer expenditures. The program embodied an important element of flexibility. This was a key feature both of our approval of the program in *PSC (Advance Payments) I*, and of our subsequent remand in *PSC (Advance Payments) II*. Nothing in the advance payment orders, not even in Order No. 499 with its express reasonable timing requirement, hinted that the pipelines were limited to line-of-credit or other conventional banking practices in the development of practical financing packages that would facilitate capital formation by producers while adequately protecting consumer interests, thus keeping advances within the confines of the program. Order No. 499 provided that as a general policy an advance should be appropriately expended within a reasonable time from "the date such amounts advanced are included in the pipeline's rate base." [83] The language of the order is instinct with latitude.

The Commission's failure to take into account the inherent flexibility of the advance payment program was the basis for our ruling in *United Gas Pipe Line Co. v. FPC*.[84] In that case, involving latitude of choice of financing methods, we vacated the Commission's summary re-

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hardship for pipeline investors. As recently as FERC v. Pennzoil Producing Co., 99 S.Ct. 765 (1979), the Supreme Court has suggested that the Commission's discretion to withhold relief from harsh application of familiar regulatory principles is not abused unless rate levels border on the confiscatory. *Id.* at 772. That case involved the Commission's equitable discretion, not the review of a determination, as in this case, of applicable legal standards arising in the context of an experimental, conditionally approved program.

[83] *See* note 37 *supra*.

[84] 179 U.S.App.D.C. 274, 551 F.2d 460 (1977).

jection of rate-base treatment for United's complex financing arrangement, which entailed an interest-reimbursement scheme rather than the lump-sum transfer of capital more typical of advance payment contracts. The arrangement contemplated that United would assist the producer to locate sources of developmental capital, and then reimburse the producer's financing costs. In our opinion for remand we noted that we found nothing in the advance payment orders precluding this method of facilitating capital formation.

In the pending case involving Transcontinental Gas Pipeline Corporation (Transco),[85] the advance payment contracts "provided for payment by Transco on January 10 and July 10 of each year of the estimated expenditures for the subsequent six months, with adjustments semi-annually and annually to reflect overexpenditures, or underexpenditures, respectively." [86] The Commission did not say one way or the other whether the pipeline acted reasonably in fashioning this procedure as a technique for controlling producer expenditures. Instead, it applied its line-of-credit rationale to exclude from rate base all advances not expended within 30 days of the close of the test period. It appears that Transco's approach of periodic accounting and adjustment, with a semi-annual review of expenditures, constituted a prima facie showing of an effort to tie payments to "qualifying expenditures." We agree with the position of the Public Service Commission of the State of New York, intervenor in the *Transco* proceeding, that in such a case "the shoe is on the other foot" and it is incumbent upon the Commission to articulate why this attempt to protect the

[85] No. 77-1712.

[86] Transco Br. in No. 77-1712 at 17-18.

consumers' interest falls outside the zone of reasonableness contemplated by the advance payment orders.[87]

We remand the cases before us for a more extensive and flexible inquiry by the Commission into the reasonableness of attempts to protect the rate payers from excessive costs. If it concludes that contracts such as those presented by Transco did provide for reasonable timing protections, the Commission would have latitude as a matter of equitable discretion to conclude that the kind of interval found reasonable in a case such as Transco's could be accepted as a general bench mark, even as to contracts that did not contain precisely the same provisions. On the other hand, based on the circumstances of a particular case, the Commission may determine that a much shorter timing interval was reasonable. For example, we note that in the proceeding involving Tennessee Gas Pipeline Co.,[88] Tennessee transferred $59 million in domestic advance payments to an affiliated producer. These advances were effected within the last 35 days of the test period, involved a mere bookeeping transfer without restrictions on the timing or nature of expenditures, and to the greater extent were not put to use in qualifying expenditures for many months.[89] The ALJ disallowed the unexpended portion of these advances because in his judgment they did not constitute an arm's length transaction. The Commission reached the same result on a different rationale, deferring rate-base treatment on the basis of the 30-day rule. On remand, the Commission may determine that such advances to affiliated producers present one example of unjustifiable misuse of the advance payment program.[90]

[87] PSC Br. in No. 77-1712 at 4.

[88] No. 77-1496 *et al.*

[89] JA in No. 77-1496 *et al.* at 313-14.

[90] We construe the pertinent advance payment orders as permitting advances to affiliated producers to be included in

It is evident that a broad range of financing practices were employed under the advance payment program. Some may have evidenced a reasonable attempt to protect rate payers from excessive costs; others, perhaps, did not. We do not prejudge the result in any particular case; such determinations are for the Commission in the first instance.

In sum, we remand these cases because the Commission failed to apply the proper legal criteria when it adminstered the "reasonable timing" aspect of the "reasonable and appropriate" standard. The advance payment orders did not require adherence to strict line-of-credit or other conventional banking practices, but rather were instinct with the attitude of flexibility and experimentation that motivated the advance payment program. The Commission correctly determined both that good faith response to competitive pressures was an inadequate justification for advance payments and that the pipelines had a responsibility to protect their rate payers from excessive costs, *e.g.*, to take reasonable steps to ensure that the timing of advances was tied to that of "qualifying expenditures." But the advance payment orders allowed a certain discretion to the pipelines and encouraged them to develop practical financing packages that would facilitate capital formation by producers while adequately protecting consumer interests, thus keeping advances within the confines of the program. Application of the correct legal standard on remand requires consideration of the various factors pertinent to a determination of the reasonableness *vel non* of the pipelines' efforts in this direction.

Account 166 on the same basis as advances to non-affiliated producers. However, there is no limitation in the orders restricting the Commission's ability to consider the affiliate relationship as one factor pertinent to application of the reasonable and appropriate standard in determining which advances included in Account 166 qualify for rate base-treatment.

2. *Latitude on remand.* The Commission has latitude under its statute to use its equitable discretion and to choose alternative procedures or mechanisms to formulate and to effectuate its judgment;[91] the result need not require a painstaking readjustment of rate base in each case.

The Public Service Commission of the State of New York, an active and helpful participant in all phases of the development, administration, and review of the advance payment program, calls our attention to the interrelationship between the Commission's ruling on the advance payment question and its determination on rate-of-return. In the *Tennessee* proceeding,[92] the Commission readjusted upwards the return on rate base allowed by the administrative law judge, on the basis of a revised assessment of the risks faced by the industry in these times of acute supply shortages. In the Commission's view, the "pendulum has definitely swung in a direction substantially contrary to the interests of the investor. A time of adjustment is clearly called for."[93] One of the risks incurred by the pipelines has been the "regulatory risk" that an experimental program such as advance payments might miscarry, and that administrative readjustment would not prevent substantial adverse impact. Commissioner Smith, whose vote in *Tennessee* was necessary to form the majority, expressly premised his concurrence on the link between treatment of advance payments and rate of return.[94] On remand the Commission will have

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[91] FCC v. Pottsville Broadcasting Co., 309 U.S. 134 (1940); Vermont Yankee Nuclear Power Corp. v. NRDC, 435 U.S. 519 (1978).

[92] No. 77-1496 *et al.*

[93] Opinion No. 769, *supra* note 44, at 22; JA at No. 77-1496 *et al.* at 341.

[94] *Id.*, Commissioner Smith, concurring, at 4; JA in No. 77-1496 *et al.* at 357 ("The overall result [on rate of return] is

discretion to consider this interrelationship in reaching a just result. In the other two cases before us, the rate-of-return issue was settled prior to determination of the advance payment question. If the Commission prefers to use rate of return as the vehicle for adjustment, it may consider whether it should reopen these settlement agreements.[95] Another mechanism for effecting the final just and equitable result is the ordering of only partial refunds, rather than the readjustment of rate base. The Commission retains a broad discretion in such matters.[96]

One other significant factor that the Commission may consider in exercising its latitude on remand is the impact on the industry of the entire course of Commission action in the development and administration of the advance payment program.[97]

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supportable only because of the treatment given advance payments.").

[95] By purporting to "settle" rate of return yet leaving open the treatment of advance payments, such settlements may have been rooted in an erroneous premise that these issues could be put in separate analytic compartments and resolved independently.

[96] As noted in Niagara Mohawk Corp. v. FPC, 126 U.S. App.D.C. 376, 382, 379 F.2d 153, 159 (1967), "the breadth of agency discretion is, if anything, at zenith when the action . . . relates primarily not to the issue of ascertaining whether conduct violates the statute, or regulations, but rather to the fashioning of policies, remedies and sanctions."

[97] In another context, we approved the Commission's determination to ignore the varied impact on producers of the advance payment program, and to make a "clean start" in its prescription of a national rate. The Second National Natural Gas Rate Cases, 186 U.S.App.D.C. 23, 59-64, 567 F.2d 1016, 1052-57 (1977), *cert. denied*, 435 U.S. 907 (1978). But that situation involved allocation among producers of uneven *gains*, and prescription of rates for the future. The pipelines are in a different posture. The Commission has latitude to consider whether the pipelines were caught between a rock and a hard

It is appropriate to conclude our discussion of Latitude on Remand, before going on to subsidiary issues, to emphasize that while the court has identified a number of factors for consideration by the Commission, it is aware that the appraisal and weighing of these factors is the function of the agency and not of the court. It is not an encroachment on the agency's ultimate discretion either that the court has identified a number of factors for consideration, or that Judge Wilkey has indicated that in his view a particular emphasis should be given to certain factors. The court's role, permitting intervention for error of law or arbitrary action, still leaves the agency

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place and took actions which they reasonably believe were in the best interests of their customers. This appears to be the thinking of the Public Service Commission of the State of New York. PSC Br. in No. 77-1498 at 14.

There is the further consideration that the ambiguity of the advance payment orders on the timing question may have served the producers as a kind of legal lever to overcome pipeline resistance. In the context of an exception to settled principle, which permitted some "advance" payments, the combination of FERC indefiniteness in the first instance and inaction later on may have given momentum to extended front-end advances. If the FERC takes the view that the ability of the pipelines to resist untoward advances was materially weakened by the agency's handling of the issue, it has latitude to take this into account. In this regard it would be appropriate for the Commission to consider the contrast between Order No. 465, with its absence of any explicit reference to the timing issue, and the notice provided to both pipelines and producers in Order No. 499 that advances must be appropriately expended by the producer within a "reasonable time."

The impact on the natural gas industry of the advance payment program has been likened to the mark left on a landscape by the wreckage from an airplane disaster. *The Second National Natural Gas Rate Cases, supra*, 186 U.S.App.D.C. at 64, 567 F.2d at 57. The Commission has latitude in the circumstances to fashion an equitable allocation of burdens between the rate payers and the pipeline investors.

with a function broader in scope than the court's.[98]

Although our ruling pertains to the rate-base determinations raised by the petitions before us, the Commission has flexibility to consolidate these with other cases, to engage in rule making, or to adopt other procedures. In the end, the Commission may choose to adopt a simplifying formula in the interests of feasible administration; but such a resolution must reflect a reasoned consideration of all the pertinent factors, demonstrating the flexibility that always has been inherent in the advance payment program.

II. Other Issues in No. 77-1496, *et al.*, *Tennessee Gas Pipeline Co. v. FERC*

We turn to two subsidiary questions raised by the petitions for review.

A. *Canadian Advance Payments*

The first question is whether the Commission properly excluded from Tennessee's rate base advance payments made to a Canadian producer. We approve the Commission's determination.

The Commission affirmed the ALJ's decision to exclude from rate base $37.5 million in advance payments made by Tennessee to an affiliated Canadian producer, for use in exploration and development activities in the Canadian Artic Islands, a remote area in the northern reaches of Canada.[99] We discern that the principal basis of the

[98] The vitality of these principles appears from their early statement, *e.g.*, FCC v. Pottsville Broadcasting Co., 309 U.S. 134 (1940), and their recent reiteration, *e.g.*, FERC v. Pennzoil Producing Co., 99 S.Ct. 765 (1979), discussed in note 81 *supra*.

[99] Opinion No. 769, *supra* note 44, at 33-34, JA in No. 77-1496, *et al.* at 352-53; Opinion No. 769-A, *supra* note 32, at 10-13, JA in No. 77-1496, *et al.* at 401-04. *See* JA in No. 77-1496, *et al.* at 297 (map).

Commission's determination was Tennessee's failure to demonstrate "that receipt by the appropriate American consumers of the Canadian gas . . . will most likely occur." [100]

The advance payment orders were expressly limited to domestic advances.[101] The Commission stated that "[t]he sole basis for even considering Canadian advance payments is our prior statement that pending a Canadian advance payment rulemaking such advances 'shall be treated on a case by case basis.' " [102] The Canadian advances were made in 1973 and Tennessee sought to have them charged to the contemporaneous rate payers, though it concedes that no gas will be forthcoming until the mid-1980's.[103] These advances were not "used and useful" for providing service to then current rate payers, and traditional rate making principles would call for exclusion from rate base.[104] The Commission's analysis seems to contemplate an exception from traditional principles, permitting rate base inclusion on a showing that a particular advance payment served the same purposes, and promised an equivalent benefit to rate payers, as those envisioned for domestic advances complying with the advance payment orders.

The fundamental objective of the advance payment program was to help elicit requisite gas supply by providing capital for expedited development and production during the interim period until an upward revision in

[100] Opinion No. 769-A at 12, JA in No. 77-1496, *et al.* at 403.

[101] *See* note 25 *supra*.

[102] Opinion No. 769-A at 11, JA in No. 77-1496, *et al.* at 402, *quoting* Notice of Rulemaking, *supra* note 25, 38 Fed. Reg. at 1056.

[103] *Id.* at 13, JA in No. 77-1496 *et al.* at 404; Tennessee Br. in No. 77-1496, *et al.* at 66.

[104] *See* text accompanying notes 51-55 *supra*.

producer rates would accomplish this objective.[105] The ends of the program could not be furthered unless the investments that were precipitated by advance payments inured to the benefit of jurisdictional rate payers. For this reason the program expressly assured that rate payers would not be charged for advances that did not produce gas, or that produced gas which did not flow to the advancing pipeline.[106] Similarly, as to Canadian advances, the Commission here required that the gas resulting from such advances must be shown "most likely" to flow to the advancing pipeline's domestic rate payers. This general approach was well within the Commission's broad discretion and consistent with that taken in previous adjudications.[107]

More specifically, the Commission concluded that Tennessee had not carried its burden of showing that Arctic Islands gas would "most likely" flow to rate payers in the United States. Several uncertainties remained, *e.g.*: (1) whether reserves in the Arctic Islands region were sufficient to justify construction of a pipeline; (2) whether, at the time this gas would become available for market, Canada's total reserve situation would justify granting of the necessary export authorizations by the National Energy Board of Canada (NEB); and, (3) whether, assuming the existence of adequate reserves, the NEB would grant the required authorizations, rather than authorizing additional exports from other gas-producing regions, or otherwise modifying Canadian energy policy. As we recently have had occasion to note, in the present era of uncertainty for natural gas supply any attempt to pre-

[105] *See* text accompanying notes 56-66 *supra*.

[106] *See* note 34 *supra*.

[107] *E.g.*, Opinions No. 672 & 672A, Texas Eastern Transmission Corp., Docket No. RP70-29, *et al.*, 50 FPC 1419 (1973), 51 FPC 258 (1974), *aff'd*, 171 U.S.App.D.C. 25, 517 F.2d 1299 (1975).

dict NEB export policy is highly speculative.[108] The very existence in this case of a genuine dispute over the interpretation of a series of inconsistent and conflicting NEB reports is sufficient to support the Commission's judgment that the issue is not free from substantial doubt. We will not disturb the Commission's informed judgment when it acts as here, within an area of its special expertise and discretion.

B. *Rate of Return*

The second subsidiary issue is whether the Commission erred in allowing Tennessee a 13.75% return on equity.

In proceedings before the administrative law judge, Tennessee argued for a 13.35% rate of return on equity; Staff proposed an 11.6% return. The ALJ concluded that a return of 12.5% on equity was "reasonably in line with earnings of enterprises with comparable degrees of risk, and which have similar ratios of common equity capital."[109] The Commission set aside this determination and adopted a return of 13.75%. In the Commission's view, the "pendulum [had] definitely swung in a direction substantially contrary to the interests of the investor. A time of adjustment [was] clearly called for."[110]

[108] Midwestern Gas Transmission Corp. v. FERC, —— U.S. App.D.C. ——, 589 F.2d 603 (1978) (ruling, *inter alia*, that certain of petitioner's claims were not ripe for review since they depended on the speculative effect on future NEB export policy of FERC action regarding the Alaska Natural Gas Transportation System). *See id.* at 622 n.107.

[109] Initial Decision in No. 77-1496 *et al.* at 23, JA in No. 77-1496, *et al.* at 307. This ruling would have resulted in overall return on rate base of 8.787%. *Id.*

[110] Opinion No. 769-A at 22, JA in No. 77-1496, *et al.* at 341. This ruling resulted in an overall return on rate base on 9.25%. *Id.* at 23, JA in No. 77-1496 *et al.* at 342.

New York Public Service Commission argues that the Commission's ruling on rate of return was inextricably bound to its advance payments determination.[111] PSC also challenges the reasonableness of the allowed return on equity. We have suggested that on remand for reconsideration of the advance payments determination, the Commission should again evaluate the rate of return question, which it would have full authority to do even if the allowed return were valid in all respects, *FCC v. Pottsville Broadcasting Co.*, 309 U.S. 134 (1940). We think it appropriate to refrain from entering a ruling at this time on this issue, pending further consideration on remand.

III. Other Issues in No. 77-1712, *Transcontinental Gas Pipe Line Corp. v. FERC*

Two subsidiary issues are raised by Transco's petition for review: (1) whether the Commission erred in excluding from Transco's rate base expenditures for unsuccessful alternative gas supply projects; and, (2) whether the Commission properly rejected an offer of settlement. We affirm the Commission's rulings.

A. *Expenditures for Alternative Gas Supply Projects*

The Commission affirmed the ALJ's exclusion from rate base of over $22 million expended by Transco in four unsuccessful projects related to the production of synthetic natural gas (SNG).[112] The pipeline argued

[111] *See* text accompanying notes 92-95 *supra*.

[112] Expenditures of $10.1 million related to a study of the technical and economic viability of converting Middle Eastern crude oil into synthetic natural gas of pipeline quality. Over $9.8 million was devoted to a project for conversion of naptha feedstock into SNG. A study of a program to use natural gas reserves located overseas by converting the gas to crude methanol at its source, transporting the methanol by conventional tankers to the United States, and converting the methanol into natural gas cost $1.4 million. Over $920.000 was spent on a project to produce methane from coal. Initial Decision in No. 77-1712, *supra* note 26, at 5-7, JA in No. 77-1712 at 122-24.

that these amounts should be included in rate base to be amortized as expense items for inclusion in cost of service. Thus Transco sought both a return *on*, and the return of its investments. The Commission found that the expenditures were not "used and useful" in providing service and should not be charged to the rate payers.[113] Since the projects did not produce any jurisdictional gas, this ruling clearly was a proper exercise of discretion.[114] We find without merit the claim that the Commission had established a policy, relied on by Transco, creating an exception from the traditional "used and useful" principle with respect to expenditures for SNG development.[115] The Commission had established such an exception for research and development costs, but the Transco projects failed to qualify for special R & D treatment.[116]

[113] Opinion No. 801-A, *supra* note 46, at 2-3, JA in No. 77-1712 at 202-03.

[114] *See* text accompanying notes 51-55 *supra*.

[115] The Commission had previously demonstrated its reliance on this principle in Tennessee Gas Pipeline Co., Opinion No. 624, 48 FPC 149 (1972), *aff'd*, 159 U.S.App.D.C. 318, 487 F.2d 1189 (1973) (grant of a certificate to construct liquified natural gas facilities conditioned to prevent rate-base treatment of costs if the project proved unsuccessful). In addition, the Commission's uniform System of Accounts for Natural Gas Companies, 18 CFR 201 (1978), provided clear notice that pipeline investors must absorb costs of abandoned projects involving "preliminary survey plans, investigations, etc. made for the purpose of determining the feasibility of utility projects under contemplation . . . to provide a future supply of natural gas." *See* PSC Br. in No. 77-1712 at 11.

[116] *See* 18 CFR 201(103) (1978) (requiring, *inter alia*, use of experimental technology and prior Commission approval—

These expenditures were prudent investments, argues Transco; however, for rate base inclusion expenditures must satisfy not only the necessary condition of prudent investment but also must be "used and useful" in providing service. The Commission did not abuse its discretion when it applied a policy "that SNG expenditures which do not qualify as R & D can be recovered, if at all, only through the price paid for actual SNG production sold in interstate commerce." [117]

B. *Rejection of Transco's Settlement Offer*

On the basis of the above reasoning, we affirm the Commission's concise rejection of a settlement offer that proposed to exclude these project costs from rate base, yet to amortize most of them over a five-year period for inclusion in cost of service, thus allowing Transco to recover its unsuccessful investments.[118]

Affirmed In Part; Remanded In Part For Further Consideration.

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both absent from Transco's projects); Opinion No. 801-A at 3, JA in No. 77-1712 at 203.

[117] Opinion No. 801-A at 4, JA in No. 77-1712 at 204.

[118] *See* Opinion No. 801 at 8, JA in No. 77-1712 at 172.

WILKEY, *Circuit Judge* concurring: I concur in Judge Leventhal's carefully reasoned and skillfully crafted opinion for the court. I add this note as a concurrence-for-emphasis.[1]

In Judge Leventhal's opinion for the court the Commission has properly been allowed wide discretion in fashioning a new and more flexible rule on remand. The point I wish chiefly to emphasize is that the Commission on remand must give careful consideration to arguments raised by petitioning pipelines concerning market pressures, the ambiguity of the Commission's orders on timing of payments, and the contribution of advance payments to capital development by producers and to enhancement of gas supply. Thus I believe the court's opinion must be read as not allowing the Commission discretion to institute a new rule that is little more forthcoming in its allowances for advance payments than the now-void thirty-day rule.

As we have noted, the advance payment program constituted a significant and recognized departure from traditional regulatory principles.[2] This departure was deemed necessary to serve the important public purpose of "facilitat[ing] capital formation by [natural gas]

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[1] *See Citizens to Save Spencer County v. United States Environmental Protection Agency*, No. 78-1002 *et al.* (D.C. Cir. 27 March 1979) (Leventhal, J., concurring).

[2] *See, e.g.*, slip op. at 9 (advance payment program was a recognized "departure from the usual rule of public utility regulation . . . that current rates should reflect the cost of supplying service to current rate payers . . ."); *id.* at 31 (describing advance payment program as a clear "departure" from, and "modification" of the "used and useful" principle); *id.* at 43 ("Any permission to transfer advances prior to gas delivery . . . entailed some variance from the . . . [regulatory] situation [prior to the commencement of the advance payments program], in terms of benefit to producer and of cost to pipeline and customer.").

producers to finance development and production of new . . . supplies" in order to "alleviat[e] the impending natural gas shortage." [3] The program aimed to stimulate the process of capital formation by allowing the transfer from pipelines to producers of interest-free sums reasonably targeted for purchase or expenditures for production of identified gas supplies.[4] Natural gas producers were thus relieved of financing costs ordinarily associated with the accumulation of capital for exploration and development of new supplies.

With such significant advantages to be gained from advance payments, it is certainly correct, as Judge Leventhal has pointed out, that producers could be "expected" to bargain with the pipelines for advance payments to be made.[5] Likewise, producers could be expected to press the pipelines for advances to be made on the most favorable terms possible—*i.e.*, as long as possible in advance of their eventual "qualifying" expenditure.[6] This pressure for what we have termed "extended front-end" advances [7] was increased because the availability to producers of interest-free advance payments became one of the few

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[3] *See id.* at 7. *See also id.* at 14 ("theory" of the program was that "increased availability of capital would encourage investment, which in turn would yield additional gas supply").

[4] *See id.* at 42 ("A producer receiving an extended front-end advance, to use without restriction for a significant period prior to expenditure, is in effect given a sum of money.").

[5] *See id.* at 8.

[6] The court's opinion has employed the term "qualifying expenditure" to identify "those producer expenses permissible under the [advance payments] program." *See id.* at 8.

[7] The court has devised the novel and useful term "extended front-end advance" to describe those advance payments barred from current rate base treatment by Commission orders here under review. *See id.* at 14.

negotiable terms of gas supply contracts in the otherwise closely regulated natural gas market.

As a result of tight gas supplies during the years of the program at issue here,[8] bargaining attempts of the producing companies met with particular success as pipelines scrambled to secure supplies of gas for customers. Since it was in order to relieve this plight of tight supply that the program was initiated, however, this superior bargaining position of the producers and their consequent bargaining success should have come as no surprise to the Commission.

Furthermore, no evidence on the record suggests that contracts providing for advance payments were negotiated covertly. Instead, all available information suggests that the high degree of administrative, judicial, and public scrutiny afforded the advance payment program made the terms of the vast majority of advance payment contracts well known to outside parties, and certainly to the responsible regulators.

It is thus particularly astonishing that, as noted in the court's opinion, "[t]he advance payment orders [issued by the Commission during the program] did not specify the permissible interval between the advance and its appropriate expenditure." [9] Order No. 465 contained what has properly been described as a totally "unelaborated statement" that advance payments would be allowed only where "reasonable and appropriate," with no specific reference to the critical issue of *how long* in advance of designated use such payments could be made.[10] Subsequently, Order No. 499 made a completely unimpressive advance toward specificity by declaring that

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[8] These years were 1973, governed by FERC Order No. 465, and 1974-75, governed by FERC Order No. 499. *See id.* at 11.

[9] *See id.* at 17.

[10] *See id.* at 20.

only those advances made within a "reasonable time" of eventual expenditure would be allowed.[11] Until long after the expiration of the advance payment program, therefore, the Commission through its applicable Orders provided only the most cryptic and ambiguous guidelines concerning the issue central to the present litigation.[12]

It thus was practically inevitable that the "flood" of advance payments propelled by Order No. 465 did not abate during the time between the two advance payment orders, or thereafter.[13] The Commission bears much responsibility for this situation, for the opacity of the Commission's orders on the issue of permissible timing could only have contributed to the disruptive effect of advance payment bargaining on the otherwise tightly metered minuet of producers, pipelines, consumers, and regulators.[14]

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[11] *See id.*

[12] The Commission order barring current rate base treatment to certain "extended front-end advances" made by Tennessee Gas Pipeline Company, for example, was issued on 9 July 1976, *see* FPC Docket No. RP73-113, Opinion No. 769, more than six months subsequent to the expiration of the advance payment program on 31 December 1975.

[13] *See* slip op. at 21 ("Despite the Commission's signal in Order No. 499 that it intended to focus on the critical timing requirement, the flood [of advance payments] did not abate.")

[14] As noted in the court's opinion, producers may have been "emboldened by . . . [the] indefiniteness [of the advance payment orders on timing]" and therefore the "producers pressed their bargaining advantage, inducing pipelines to make advances long before the funds were used for qualifying expenditures." *Id.* at 17. *See also id.* (pipelines' "weakened resistance" to competitive pressures was materially aided by "[t]he belief (or hope) that the Commission would permit rate-base treatment of extended front-end advances . . . .").

Though the court's opinion in other language has not accepted petitioners' argument that the Commission must be

The court's opinion has bent over backward to emphasize that the lack of clear regulatory guidance weakened the resistance of pipelines to the "untoward advances" of producers in eliciting extended front-end payments by pipelines.[15] We have been somewhat less defi-

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"estopped" from denying current rate base to advance payments because the Commission was on notice of the payments and the pipelines relied justifiably on agency silence, *see id.* at 44-47, the court's view on this issue is perhaps best summed up in its exceedingly cautious statement that "agency silence . . . [with regard to the scope of a departure from a well-rooted regulatory principle] must be construed to mean that traditional [regulatory] principles retain their vitality." *Id.* at 31. This modest statement, however, must be placed side by side with the court's repeated observation that the advance payment program constituted an express departure from recognized regulatory principles. *See id.* at 9, 31 & 43. Thus it is certainly consistent with the court's position to argue that the "vitality" of the Commission's regulatory principles has been diminished at least to the extent that the Commission itself has backed away from those principles. It would be insupportable for the Commission to bind an industry to regulatory principles from which the Commission has itself departed; thus I believe it is only with some difficulty that we conclude that "agency silence" on the issue of timing of advance payments did not convey a tacit and irreversible assurance that advance payments would be upheld if made in full view of the Commission and in arguable compliance with the Commission's ambiguous regulations.

[15] We have suggested, for example, that the Commission on remand has "latitude to take . . . into account . . . the view that the ability of the pipelines to resist untoward advances was materially weakened by the agency's handling of the issue . . . ," *id.* at 55 n.98, and "whether the pipelines were caught between a rock and a hard place and took actions which they reasonably believe were in the best interests of their customers," *id.* at 54-55 n.97. The Commission also has been urged to take into consideration more generally the "significant factor" of "the impact on the industry of the entire course of Commission action in the development and administration of the advance payment program." *Id.* at 54.

nite, however, in suggesting the extent of the relief that should be afforded the pipelines on remand. We have noted that the objective of the advance payment program was to facilitate the development of capital by producers in order to enhance gas supply,[16] and that advance payments by definition involve the transfer of capital from pipelines to producers.[17] We have also noted the argument of the pipelines that all advance payments must be sustained for reason of such a capital contribution, and the contrary argument of the Commission that no allowance should be made for many payments that "for the extended period between receipt [by the producers] and expenditure . . . made no . . . contribution of developmental capital [for 'qualifying expenditures'] while providing producers with a non-price incentive of the type the program explicitly sought to avoid 'as much as possible.' " [18]

The opinion of the court, however, adopts a middle position. While rejecting the pipeline's argument for carte blanche authority to make advances,[19] we have also rejected the Commission's overly narrow view of the role of advance payments in enhancing capital formation and gas supply. Any front-end advance payment, according to this court's definition, is one made prior to its use for "qualifying expenditures." [20] Also we have noted that only a sub-class of front-end advance payments may properly be disallowed current rate base treatment. This

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[16] *See, e.g., id.* at 6-7 & 14.

[17] *See id.* at 13 (an advance payment, as an interest-free loan, "substitutes for capital raised in financial markets"); *id.* at 42 ("A producer receiving an extended front-end advance . . . is in effect given a sum of money.")

[18] *See id.* at 35.

[19] *See id.* at 35-36.

[20] *See id.* at 13.

class of payments on remand will necessarily be smaller than that excluded by the Commission according to the thirty-day rule. Thus we have not determined that every advance is insupportable for the simple reason of its payment prior to expenditure; instead, we urge strict scrutiny only of those payments that may have been "extravagant" because they were made *too long* in advance of qualifying expenditures.

We reach this conclusion, I believe, in part because payments made at any interval (whether thirty days or much longer) in advance of qualifying expenditures inevitably enhanced the formation of capital in the hands of producers, and, unless diverted eventually for other non-"qualifying" purposes, may have facilitated the development of new gas supplies by reenforcing the capital foundation of the producing firms and freeing other funds for immediate productive use. It will be the task of the Commission on remand to define with some specificity and with greater latitude than previously those advance payments that were, and those that were not, "reasonable and appropriate" in conforming to the stated objectives of the program in thus aiding capital development for the purpose of enhancing gas supplies.

I have some difficulty, however, with the court's discussion of the undesirable consequences of competition among pipelines for supplies of gas. Though bidding among pipelines for gas by offering advance payments inevitably had the effect of raising prices, it cannot lightly be assumed that an increase in prices did not lead to a corresponding increase in supply. As a general matter, only in a situation of total inelasticity of supply can an increase in prices not be expected to lead to a corresponding increase in supply. No such situation of total inelasticity has been demonstrated here, and as Judge Leventhal notes, "Even in the regulatory context, market

pressures retain some vitality." [21] Thus it is clearly within the purview of our decision for the Commission to give close consideration to the extent to which bidding for gas supplies had the effect of raising prices and thus enhancing natural gas supply, in keeping with the overall goals of the advance payment program. I believe that the burden of proof rests with the Commission to demonstrate that the new rule it derives on remand distinguishes effectively between those advance payments that reasonably could, and those that reasonably could not lead to an increase in supply commensurate with any increase in price.

The Commission on remand will also want to take careful note of the losses incurred by the pipelines as a result of the Commission's rate base ruling. Though Judge Leventhal has noted for the court that the Commission's action to date has been to defer, rather than indefinitely to disqualify certain advance payments for rate base, he has also noted that "substantial sums were involved" and that "deferral has resulted in considerable losses for the pipelines' stockholders" because of interest lost during the period of deferral.[22] Such losses are not to be taken lightly, and clearly a very close question is presented as to whether these losses are substantial enough to bar the admittedly retroactive clarification by the Commission of the ambiguous language of its earlier orders on the issue of timing.[23]

The Commission will also wish to consider the equities in specific cases of a denial of current rate base to pipeline companies that may have exercised reasonable judg-

[21] *See id.* at 16.

[22] *See id.* at 27.

[23] *See* cases cited in *id.* at 45 n.77 (hardship on the affected parties a factor to consider in evaluating limitations on retroactivity of agency action).

ment in making advance payments in the context of tight gas supplies and ambiguous regulatory guidance. The pipelines have made out a convincing case that their responsibility to obtain adequate supplies for consumers during a period of scarce supply compelled them to "bid competitively for gas reserves by offering extended front-end advances." [24] Though we have not endorsed application of any "competitive business judgment" rule in this case, we have noted that circumstances may be "anticipate[d] . . . where a pipeline's investors might determine in their sound business judgment that they should take the risks associated with obtaining needed gas supplies, at least where there is a colorable legal argument that . . . [the] expenditures are permissible." [25]

I believe that under the circumstances of this case there was at least a "colorable legal argument" that many of the advance payments made would subsequently be approved by the Commission, and that any exercise of sound judgment by pipeline companies in weighing factors of consumer demand, scarce supply, and ambiguous regulation must not be lightly rebuffed by the Commission on the basis of an imputed greater wisdom of hindsight.

All of the considerations discussed above I understand to be subsumed within the court's instruction that the Commission on remand devise a new and more flexible

[24] *See id.* at 23-24; *id.* at n.44 (quoting dissenting view of Commissioner Holloman that, *inter alia*, "A pipeline . . . faced with . . . [the] competitive climate [in the natural gas market] would be remiss in its attempts to attach new supplies of gas on behalf of itself and its customers if it did not use . . . [the] tool [of offering extended front-end advances] to enter into gas supply contracts.")

[25] *Id.* at 16-17 n.30. We have also noted that at least one administrative law judge ruling on this case found that a pipeline company's "unchallenged good faith and business judgment . . . qualif[ied] advances as reasonable and appropriate." *Id.* at 24 n.45.

rule concerning advance payments. As noted in the court's opinion, "The advance payment orders . . . were instinct with the attitude of flexibility and experimentation" and "allowed a certain discretion to the pipelines and encouraged them to develop practical financing packages . . . ." [26] Though the pipelines have erred in arguing for an overbroad and overgenerous rule of universal allowances,[27] they certainly have not erred in resisting the Commission's correspondingly narrow and excessively rigid thirty-day rule. As has been made amply clear in the court's opinion, there is nothing pernicious about advance payments *per se*; [28] instead, I believe, only those advance payments that overstrain the bounds of reasonableness may be denied current rate base treatment by the Commission. Having failed once, a serious burden rests with the Commission to buttress its new rule with reasoned support.

[26] *Id.* at 52.

[27] As noted in the court's opinion, pipelines have argued that "the sole test for determining whether the advance payments made . . . were to be included in rate base . . . [should have been] whether they were made in order to obtain commitments for additional gas supplies." *Id.* at 28.

[28] *See, e.g., id.* at 14.

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

September Term, 1979

No. 77-1496

TENNESSEE GAS PIPELINE COMPANY
a division of Tenneco, Inc.,
Petitioner

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent

PUBLIC SERVICE COMMISSION OF THE STATE OF NY, et al.,
Intervenors

No. 77-1712

TRANSCONTINENTAL GAS PIPE LINE CORPORATION,
Petitioner

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent

COLUMBIA GAS TRANSMISSION CORP., et al.,
Intervenors

AND CONSOLIDATED CASES

Filed October 31, 1979

BEFORE: Leventhal and Wilkey, Circuit Judges; and Greene*, Judge, United States District Court for the District of Columbia

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* Sitting by designation pursuant to Title 28 U.S.C. § 292(a).

ORDER

Upon consideration of the petitions for rehearing filed by petitioners Tennessee Gas Pipeline Company and Transcontinental Gas Pipe Line Corp., response of respondent Commission to said petitions for rehearing, the replies thereto, and of the letter citing additional authorities submitted by petitioner Tennessee Gas, it is

ORDERED, by the Court, that the aforementioned petitions for rehearing are denied.

Per Curiam
FOR THE COURT:

/s/ GEORGE A. FISHER
George A. Fisher
Clerk

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

September Term, 1979

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v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent

COLUMBIA GAS TRANSMISSION CORP., et al.,
Intervenors

AND CONSOLIDATED CASES

Filed October 31, 1979

BEFORE: Wright, Chief Judge; McGowan, Tamm, Leventhal, Robinson, MacKinnon, Robb, and Wilkey, Circuit Judges

ORDER

The suggestions for rehearing *en banc* filed by petitioners Tennessee Gas Pipeline Co. and Transcontinental Gas Pipe

Line Corp., the response of respondent Commission to said suggestions for rehearing *en banc*, the replies thereto, and the letter citing additional authorities submitted by petitioner Tennessee Gas, all having been transmitted to the full Court and no judge in regular active service having requested a vote with respect thereto, it is

ORDERED, by the Court, that the aforesaid suggestions for rehearing *en banc* are denied.

Per Curiam
FOR THE COURT:

/s/ GEORGE A. FISHER
George A. Fisher
Clerk

APPENDIX C

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Opinion No. 801

Docket Nos. RP74-48 and RP75-3

TRANSCONTINENTAL GAS PIPE LINE CORPORATION

OPINION AND ORDER AFFIRMING IN PART AND REVERSING INITIAL DECISION ON RESERVED ISSUES AND ESTABLISHING JUST AND REASONABLE PIPELINE RATES

Issued: May 31, 1977

Opinion No. 801

Appearances

Thomas F. Ryan, Jr. and *Robert G. Hardy* for Transcontinental Gas Pipe Line Corporation

Richard A. Solomon and *Peter H. Schiff* for the Public Service Commission of the State of New York

George L. Weber, Charles R. Brown, Norman A. Flanigam, David E. Weatherwax, Phillip L. Jones, and *Henry P. Sullivan* for Consolidated Gas Supply Corporation

Joseph P. Stevens and *Barbara M. Gunther* for the Brooklyn Union Gas Company

Edward S. Kirby, William R. Duff, James R. Lacey, Richard Fryling, Jr., and *Harold W. Borden* for Public Service Electric and Gas Company

Daniel L. Bell, Jr., Giles H. Snyder, and *William P. Saviers, Jr.* for Columbia Gas Transmission Corporation

Gregory Grady, Dale A. Wright, and *Melvin Richter* for Piedmont Natural Gas Co., Inc.

Susan A. Low for the Washington Gas Light Company

William I. Harkaway, G. Douglas Essy, and *Garrett E. Austin* for Consolidated Edison Company of New York, Inc.

John E. Holtzinger, Jr., Arthur E. Gowran, Paul H. Keck, and *Steve Angle* for Atlanta Gas Light Company

Reuben Goldberg for the Pennsylvania Gas & Water Co.

Daryal A. Myse for the Georgia Municipal Association

Robert G. Simon for Carolina Pipeline Company

Eugene R. Elrod for the Staff of the Federal Power Commission

PIPELINE RATES; ADVANCE PAYMENTS; RATE DESIGN; SYNTHETIC GAS; RATE BASE; COST OF SERVICE

SMITH, Commissioner:

This proceeding arises under Section 4 of the Natural Gas Act and concerns the justness, reasonableness, and lawfulness of increased rates and charges proposed by Transcontinental Gas Pipe Line Corporation.

Procedural History

On December 17, 1973, Transcontinental Gas Pipeline Corporation (Transco) in Docket No. RP74-48 tendered proposed revisions in its FPC Gas Tariff which would have increased its revenues from jurisdictional sales by approximately $51,300,000 annually. The Commission accepted these revisions for filing by order of January 31, 1974, suspended the proposed rates for five months to become effective subject to refund on July 1, 1974, and set the matter for hearing.

Soon after the proposed rates in RP74-48 became effective but before the hearing in that docket Transco on July 16, 1974, in Docket No. RP75-3 tendered further proposed revisions to its FPC Gas Tariff which would have increased its revenues from jurisdictional sales by approximately another $48,600,000 annually. By order of August 30, 1974, the Commission accepted these further revisions for filing, suspended the proposed rates for five months to become effective subject to refund on February 1, 1975, set the matter for hearing, and consolidated Docket Nos. RP74-48 and RP75-3.

Following the submittal of prepared testimony and exhibits by the several parties to these consolidated dockets and extensive negotiations a prehearing conference was convened before Administrative Law Judge Isaac D. Benkin at which time Transco offered a proposed settlement of all issues in RP74-48 and all but three issues in RP75-3, these issues to be reserved for subsequent adjudication. The Administrative Law Judge certified this proposed settlement and related evidence to the Commission on May 16, 1975. By order of November 13, 1975, the Commission approved this settlement subject to several modifications.

In the interim between certification of the proposed settlement and Commission approval thereof hearings were held from July 29 to 31, 1975, on the three reserved issues presently at issue, these issues being the treatment of unsuccessful expenditures for alternate gas supplies, treatment of certain advance payments, and rate design. Subsequently on December 22, 1975, the Administrative Law Judge issued his initial decision on the reserved issues. Briefs on exceptions were then filed by Transco, Staff and Brooklyn Union Gas Company (Brooklyn), which also moves for oral argument and expedited decision. Briefs opposing these exceptions were filed by Transco, Staff, Brooklyn, Consolidated Edison Company of New York, Inc. (Con-Ed), Public Service Commission of New York

State (New York), and Columbia Gas Transmission Corporation and Consolidated Gas Supply Corporation (Columbia and Consolidated).

RP75-3, like RP74-48, covers a locked-in period because of a superseding filing: On March 14, 1975, Transco tendered proposed tariff revisions in RP75-75, which the Commission by order of April 30, 1975, accepted for filing, suspended for five months to become effective subject to refund on October 1, 1975. The proposed tariff revisions would constitute a jurisdictional rate increase of approximately $39,500,000 annually. RP75-75 was resolved by a settlement agreement which the Commission accepted by order of January 30, 1976.

Summary

We affirm the initial decision to the extent that it rejected rate base and cost of service treatment for unsuccessful SNG project expenditures. We reverse the initial decision, however, to the extent that certain advance payments were excluded from rate base and the *Seaboard* rate design was reestablished.

Discussion

I. *Expenditures for Unsuccessful Alternate Gas Supply Projects*

Transco had expended a total of $22,309,402 in four unsuccessful projects to manufacture synthetic natural gas (SNG)[1], and in RP75-3 it attempted to include this amount

[1] (1) $10,103,978 was spent on a study and land and right-of-way costs for a project to produce SNG from crude oil. The project was abandoned due to the high price of and the inability to secure long-term commitments for crude oil. (2) $9,860,710 was spent on a study for a project to produce SNG initially from Naphtha and later from Iranian natural gas liquids. This project was abandoned because of the unavailability of a firm feedstock supply. (3) $1,423,314 was spent on a study to convert foreign natural gas to methanol for transportation purposes, the methanol to be reconverted to gas after receipt by Transco. This project was abandoned by Iran which refused to proceed. (4) $921,400 was spent to obtain the option to reserves of coals to be converted to SNG. This project was abandoned as infeasible.

in rate base (since related accumulated deferred income taxes were first deducted, only $12,161,119 was to go into rate base) and to amortize the entire amount over five years, recovering this in the cost of service as operation and maintenance expenses.

The Administrative Law Judge rejected Transco's rate base and cost of service treatment of this $22,309,402 of unsuccessful SNG project expenditures. In reading Commission precedent concerning treatment of an unsuccessful LNG project[2] he found that Transco's jurisdictional ratepayers should not bear the costs of these unsuccessful SNG projects because Transco failed to obtain advance Commission approval for these projects. He did not base this rejection upon the mere fact that the projects were unsuccessful, as well as nonjurisdictional. While he noted that the nonjurisdictional initial status of SNG facilities relieved Transco of the duty to seek prior approval, he concluded that the ratepayer should be protected by the Commission from such risky investment decisions unless the Commission has first had an opportunity to assess the project. He also noted in passing that the four unsuccessful SNG projects at issue could not be characterized as research and development, a characterization which according to him would have improved Transco's chances to amortize these costs despite the lack of advance approval.

In excepting to this finding Transco first of all attempts to distinguish *Tennessee, supra* note 1, (the LNG project therein required certification, refusal to permit recovery

[2] *Tennessee Gas Pipeline Company*, Opinion No. 624, 48 FPC 149 (1972), *aff'd Tennessee Gas Pipeline Company* v. *F.P.C.*, 487 F. 2d 1189 (D.C. Cir. 1973).

of its costs was a certificate condition which the pipeline had accepted, the LNG project was not research and development, and it was to serve only a few customers) and secondly relies upon prior Commission precedent [3] for the proposition that the cost of unsuccessful projects to improve systemwide service, such as the four herein, should be recovered. Transco moreover attacks the "advance approval" test as unworkable since large preliminary expenditures are needed before a project is even ready to be presented to the Commission for advance approval and also as discouraging the pipeline initiative needed to solve the gas shortage. Transco concludes that it should be permitted the proposed rate base and cost of service treatment because these SNG project expenses were prudently incurred and were intended for the benefit of its entire system.

While Staff supports the result reached in the initial decision, it excepts to the underlying rationale, to-wit, the "advance approval" test. It argues that, since the Commission normally reserves approval of project cost flow-through until the resulting benefits are available to the jurisdictional customers, advance presentation of these SNG projects would most likely be met by deferral, not approval. Staff reads *Tennessee, supra* note 1, 48 FPC at 156 to preclude recovery of the costs of any unsuccessful non-research and development project; however, Staff would argue for rate base and cost-of-service treatment upon a showing of extraordinary circumstances, which allegedly was not made herein.

In opposing Staff's position Transco first of all reiterates the uncontroverted prudency of its expenditures, secondly assails the validity of the standard that all unsuccessful projects be excluded except under extraordinary circum-

[3] *Midwestern Gas Transmission Company*, Opinion No. 444, 32 FPC 993 (1964); and *Southern Natural Gas Company* Opinion No. 379, 29 FPC 323 (1963).

stances, and finally, asserts that in any event extraordinary circumstances exist, to-wit: the Arab oil embargo.

New York supports the "advance approval" test enunciated in the initial decision, but it would limit such a standard to prospective application only in light of its recent formulation. It would, however, continue to support rejection of Transco's rate base and cost of service treatment of the unsuccessful SNG project expenditures because the unavailability of feedstock would have precluded any form of Commission approval and no extraordinary circumstances were demonstrated.

We find that Transco's proposed rate base and cost of service treatment of the unsuccessful SNG project expenditures should be rejected, and accordingly the result reached in the initial decision should be affirmed although different supporting rationale is presented.

It should first of all be pointed out that Transco's four SNG projects, *supra* note 1, did not constitute "research and development", which, pursuant to *Tennessee, supra* note 2, 48 FPC at 158, would have justified both rate base and cost of service treatment so long as the pipeline sought and obtained prior Commission approval. Neither the record nor Transco's arguments on brief in any way indicate that these expenditures should be classified as "research and development." Moreover, even if it had met its burden of proof in this regard, Transco would still fail for it did not inform the Commission in advance of the experimental nature of the projects: The Commission should not shift the risk of failure of research and development projects to the ratepayers unless it is first "given an opportunity to determine whether such expenditures were appropriate and in the public interest to possibly increase the natural gas supply."

Secondly, the obvious fact that these projects were unsuccessful removes them from that general precept that

the costs of exotic supplies, whether SNG or LNG, are recouped along with a fair rate of return through the pipelines sales of such supplies at a fixed certificated rate, whether rolled-in or incrementally priced.[4]

The four unsuccessful SNG projects themselves were clearly nonjurisdictional,[5] but that fact alone is not dispositive. In that SNG projects are nonjurisdictional, the pipeline has the option to either sell the production in intrastate commerce so as to totally avoid Commission regulation or to obtain Commission certification of the transportation and/or sale of the SNG in interstate commerce. The potential for abuse by the pipeline is apparent under Transco's position: If the project is a success, it can choose to sell the SNG in intrastate commerce, but, if the project fails and produces no SNG, the pipeline merely includes the expenditures in rate base and amortizes them through the cost of service. No protection has been afforded the jurisdictional ratepayer under this scenario.

The Administrative Law Judge recognized this problem and attempted to remedy it by instituting his "advance approval" test. His reliance upon *Tennessee,* however, is not completely warranted. The Commission therein granted conditional approval to the LNG facility because it was jurisdictional, thereby necessitating a Section 7 certification proceeding. While advance certification of any SNG project is both advisable and common, the resulting certificate would never provide for recovery of expenditures if the SNG project failed.[6] In Opinion No. 728 the Com-

[4] *Columbia LNG Corporation, et al.,* Opinion No. 622, 47 FPC 1624 (1972); *Algonquin LNG, Inc. et al.,* Opinion No. 637, 48 FPC 1216 (1972).

[5] *El Paso Natural Gas Company, et al.,* Opinion No. 663, 50 FPC 651 (1973); *aff'd sub nom. Alice Henry, et al.* v. *FPC,* Nos. 73-2090, *et al.* (July 28, 1975, D.C. Cir.).

[6] *Transwestern Coal Gasification Company,* Opinion No. 728, Docket No. CP73-211, issued April 21, 1975 (slip op. at 16-17).

mission categorically refused to approve a "full cost of service tariff" whereby the pipeline would be guaranteed the recovery of all of its project costs over twenty-five years even if an Mcf of SNG was never produced. The Commission established an initial rate, subject to certain later adjustments, through which all reasonable and prudent costs would be recouped, if at all, through the sale of SNG at certain estimated levels. In the instant proceeding Transco's proposal is sufficiently analogous to Transwestern's proposed full cost of service tariff to require rejection for the same reason.

Although we support further SNG development, the jurisdictional ratepayer should not bear the full risk. As in the case of Transwestern, the Commission has demonstrated a sensitivity for the vagaries of inflation.[7] Production of SNG by the pipeline is analogous to the production of natural gas by independent producers, however, and the same shareholder risk should apply.

On July 2, 1976, Transco filed with the Commission a unilateral offer of settlement of the unsuccessful SNG project expenditures issue and an attached motion for approval of that settlement. While we reject this settlement on the merits for the reasons stated hereinafter, we also express our disapproval of the settlement for a very compelling procedural and administrative reason; that is, the benefits of economy and expedition arising from Commission acceptance of proposals for settlement of adjudicatory proceedings are nonexistent in the present context. Specifically, the parties to both RP74-48 and RP75-3 previously agreed upon a settlement of most of the issues therein, but they could not agree upon the three reserved issues herein. This resulted in a hearing, initial and reply briefs, issuance of an initial decision, briefs on exceptions and briefs opposing exceptions, and finally Commission

[7] *Transwestern Coal Gasification Company, et al.,* Opinion No. 728-A, Docket No. CP73-211, issued November 21, 1975.

resolution of the issues. We see no benefits accruing to the public interest from considering this unilateral settlement which of course would require our pretending that a full year of hearings, briefs, initial decision and Commission analysis never occurred.

In any event Transco's unilateral settlement offer should be denied on the merits. This offer of settlement was noticed on July 30, 1976, and comments were thereafter filed by Staff, Brooklyn, and New York. Brooklyn and New York support the offer of settlement.

Transco's offer of settlement consists of the removal from cost of service of all costs ($9,860,710) of its naphtha gasification project, along with the removal from rate base of its other three unsuccessful SNG projects, *supra* note 1. Essentially under the settlement Transco would only be allowed to recover through cost of service the amortized portion of the three remaining unsuccessful SNG projects. Transco alleges that the settlement would reduce its previously proposed $6,977,140 annual cost of service recovery for the SNG project costs to $2,870,343.

Although we do not necessarily feel that, in light of the particular circumstances surrounding this "eleventh hour" offer of settlement, the Court ruling in *Michigan Consolidated Gas Company* v. *FPC*, 283 F.2d 204 (D.C. Cir. 1960), *cert. denied, sub nom, Panhandle Eastern Pipe Line Company* v. *Michigan Consolidated Gas Company*, 364 U.S. 913 (1960) compels us to consider this offer of settlement on the merits, we shall nonetheless do so. We have already found as a matter of law and policy, *supra*, that the full unsuccessful SNG project study costs should be excluded both from rate base and cost of service recovery. Transco now seeks only cost of service recovery for three of the four projects. Although the cost to the consumer would obviously be less than under its original and fully litigated proposal, it would nevertheless be more than what we have already determined to be the proper

treatment, which is no recovery. The reduced amount of the request does not obviate our prior finding which applies equally to all four projects and to both rate base inclusion and cost of service recovery.

II. *Rate Design*

Transco had previously designed its two-part demand-commodity rate under the 50-50 *Seaboard*[8] formula by which 50% of fixed costs are assigned to the demand charge and the other 50% of fixed transmission and storage costs, as well as all variable costs, are assigned to the commodity charge. Its proposed rates in RP74-48 and RP75-3 were designed, however, under the 25-75 *United*[9] formula by which only 25% of fixed transmission and storage costs are assigned to the demand charge and the other 75% of fixed costs and all variable costs are assigned to the commodity charge. Nevertheless Transco sought reversion to *Seaboard* rate design throughout the hearing and on brief. Only Staff supported rate design based upon the 25-75 *United* formula. Under the settlement agreement in RP74-48 and RP75-3, as well as a subsequent settlement agreement in RP75-75, the rate design issue is to have prospective effect only from the date of the final order herein.

The Administrative Law Judge ordered that Transco redesign its jurisdictional rates according to the *Seaboard* method. In rejecting Staff's insistence upon the 25-75 *United* rate design formula he first of all found that a prime Commission objective in *United*, to discourage the low priority industrial use of gas, cannot be achieved on the Transco system once Transco has only one direct

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[8] *Atlantic Seaboard Corporation*, Opinion No. 225, 11 FPC 43 (1952).

[9] *United Gas Pipeline Company*, Opinion No. 671, 50 FPC 1348 (1973), *aff'd sub nom, Consolidated Gas Supply Corporation, et al.* v. *F.P.C.*, Nos. 74-1343, *et al.* (D.C. Cir. October 9, 1975).

industrial customer (he ignored indirect industrial customers behind Transco's distributor customers because of an absence of Commission jurisdiction over them). He moreover rejected the *United* formula because he found that it would discourage distributor investment in peak-shaving facilities (storage, SNG, LNG) used to improve load factor for under *United* more fixed costs are shifted from low to high load factor customers. He then reinforced his conclusion by finding that the shift of fixed costs from the demand to commodity charge would increase Transco's risk of undercollection of fixed costs, which would occur if the level of curtailment increased over the sales estimates employed in setting these rates. He concluded by pointing to Transco's demand charge adjustment and the Commission's proposed rule-making for end-use rates as more direct and effective methods for achieving the goals which this rate design proposal attempts to achieve indirectly.

Staff vigorously excepts to the initial decision concerning rate design. To begin with, Staff asserts that the Commission has disclaimed basing the 25-75 *United* formula upon discouraging industrial gas consumption and that the Court in affirming *United* has recognized this disclaimer, *supra* note 9. This assertion is made to counter the Administrative Law Judge's finding that a *United* rate design would not in this case discourage industrial gas use.

Secondly, Staff contests the finding that a change from *Seaboard* to *United* rate design will discourage investment by distributors in storage facilities. While Staff concedes that this rate design change will reduce the price discount received under *Seaboard* by the high load factor distributors it contends that this will not discourage storage investment for such high load factor customers still receive a significant price discount under the *United* rate design and any increase in the unit cost of gas to these high load factor distributors will in any event be passed on to their retail customers.

Thirdly, Staff discounts the Administrative Law Judge's reliance upon the increased financial risk to Transco resulting from a shift from *Seaboard* to *United* rate design, pointing out that while the Commission has already recognized this increase in risk for the pipeline, it remains committed to the *United* rate design and views careful estimating of future sales volumes when preparing a rate increase filing as sufficient protection against such increased risk.[10] Staff also finds judicial support for refusal to reject the *United* formula because of the increased financial risk of underrecovery, *supra* note 9.

Staff furthermore reiterates its fundamental rationale behind the *United* formula, which is that the shift of fixed costs recovery from the low load factor customers to the high load factor customers is justified because the latter group is receiving more gas than the former. (Staff refutes the Administrative Law Judge's statement that Staff assumes that this differential in deliveries is due to curtailment): By increasing the unit price of gas to the high load factor customer, those which receive more gas, the 25-75 *United* formula is seen by Staff as encouraging conservation. It contends that the Court in *Consolidated, supra* note 9, recognized that the *Seaboard* formula in comparison to the *United* formula encourages gas consumption. Staff attacks this promotional aspect of *Seaboard.* In discounting the Administrative Law Judge's further reasoning supporting the *Seaboard* formula (it is not equitable to shift fixed cost recovery from the low load factor customers to the high load factor customers because the customers developed their respective load factors prior to curtailment), Staff argues that this historical load factor disparity is no longer a reasonable basis for *Seaboard* because the subsequent occurrence of the natural gas shortage has caused an underutilization of Transco's system on both a

[10] ***Trunkline Gas Company,*** Docket No. RP74-89, issued July 9, 1975 (Slip. Op. at 5).

peak and annual basis. (Tr. 469, 471, 487, 659-662, 714-719, 776, 872; Exh. 37, 38, 41). Staff stresses that this underutilization of Transco's system on both a peak and annual basis is sufficient justification by itself for changing from *Seaboard* to *United* rate design and that both the Court, *supra* note 9, and the Commission, *supra* note 10, have espoused this view.

Transco, Brooklyn, Columbia and Consolidated, and New York all oppose application to Transco's rate design of the *United* method. For example, New York argues that there is no evidence supporting Staff's position that the *Seaboard* rate design encourages gas consumption: It finds no conservation resulting from use of the *United* rate design. It also asserts that a shift to *United* would discourage the present low-load factor customers from investing in storage even if the present high-load factor customers would retain some price discount. New York concludes by viewing Staff's rationale behind *United*, to shift costs from low-load factor to high-load factor customers because the latter receive more gas than the former, as an indirect attempt at "compensation", which, if at all, should be addressed in the curtailment docket.

Brooklyn, as well as Columbia and Consolidated, preface their opposition to Staff's exception on rate design by enumerating distinctions between the *United* case, *supra* note 9, and the Transco system which they contend constitute sufficient legal differences to retain the *Seaboard* rate design: While United could not meet its peak day requirements, Transco's *seasonal* curtailment plan permits it to deliver its full contractual volumes on any given day; unlike United's tariff, Transco's tariff contains a demand charge adjustment and related commodity surcharge through which the fixed costs assigned to those demand charges which are curtailed are recovered through the commodity charge; while United has about 200 direct industrial customers, Transco has *de minimis* direct industrial sales; and although the high-load factor customers of United were generally the lower priority industrial users, Transco's high-load factor customers are distributors serving mainly residential and small commercial consumers. They also reiterate the impact on storage and financial risk to Transco, reasons advanced in the initial decision, as well as asserting that Staff has no cost-based evidence supporting the *United* rate design.

We find that the holding in the initial decision to redesign Transco's rates under the *Seaboard* method should be reversed. We are of the view that the facts of this case support a rate design based upon the *United* methodology.

There can be no dispute that the shifting of fixed costs resulting from a rate design change from *Seaboard* to *United* will increase the unit price of gas paid by high-load factor customers and will conversely decrease the unit price of gas paid by low-load factor customers, although these low-load factor customers will still pay higher unit prices (Tr. 473-A, 666). Moreover, to the extent that a low-load factor customer could improve its load factor by installing storage, a shift from *Seaboard* to *United* rate design will to some extent have a discouraging but not necessarily controlling effect. Under today's gas supply shortage it is necessary that pipeline and distributor companies take every action necessary to assure continued service to high priority loads. The construction of peak shaving facilities is an important step in the maintenance of gas service and the decision to construct such facilities will rest upon service requirements rather than rate design. This is apparent from the nature of Transco's interim curtailment plan wherein distributors and end-use customers alike are encouraged to use their best efforts to acquire peak shaving, supplemental supply sources, and storage whenever technologically and economically feasible.

We wish to clarify several points of law and fact which appear confused in the initial decision and the briefs. First

of all, as both the Commission in *United* and the Court in *Consolidated, supra* note 9, have recognized, "[t]he development of extreme gas shortages and the resulting existence of large unused pipeline capacity provides a reasonable basis for reducing the demand component of the tariff charge and moving away from a marked peak differential." In other words underutilization of the pipeline's system warrants a shift of fixed costs to the commodity charge. Even though Transco could theoretically meet all the requirements of any customer on a peak day because its curtailment plans is seasonal and not daily (Tr. 474, 500), the record makes clear that Transco's pipeline system is under-utilized on both an annual and a peak day basis. (Tr. 474, 477, 481-482, 487, 659-662, 672-673, 675-677, 776; Exhibits 37, 38, and 41). Statements in the record to the effect that in the past Transco has met 100% of the delivery requirements nominated or requested by its customers on a peak day are misleading and do not controvert the finding that Transco cannot meet its peak day requirements. This is true because Transco's customers must schedule their "requests" from Transco in the winter season in a carefully planned manner; actually, to insure that adequate supply is available late in the winter heating season each customer must schedule his "requests" from his winter seasonal entitlement in much the same manner as companies operate storage pools. For this reason, it would be highly unlikely that a customer would "request" his contractual entitlement on more than a few days in the winter season, and on a system as large as Transco's it would be extremely unlikely that all its customers would "request" their contract entitlement on the same day. However, in the event this latter event occurred, the evidence also indicates (Tr. 472) that on a coincidental peak day Transco would be unable to meet all of its requirements. Therefore, the record clearly demonstrates that Transco has a large amount of unutilized capacity on its system on both the peak day and the average annual day which leads us to the conclusion that from a utilization of capacity standpoint there is no

difference between the Transco system, as shown in this record, and the United system, as shown by the record that lead to our decision in Opinion No. 671.

We next address the Judge's reasons for arriving at his decision that a *Seaboard* rate design is appropriate for the Transco system. Regarding the subjects of "discouraging low priority use" and the "risks associated with shifting fixed costs to the commodity charge" we find that the staff has correctly interpreted our orders [11] and that the Judge's findings in these regards are no bar to a decision that a *United* rate design is appropriate for the Transco system.

We believe that the Judge's finding that a rate design based upon the *United* formula would discourage distributor investment in peak-shaving facilities cannot be supported on the basis of an analysis of the present availability of natural gas. In the past, when natural gas was available in quantities sufficient to meet demands, a distributor's decision to invest in a peak-shaving facility or to contract for additional gas supply from its pipeline supplier was principally an economic decision in which rate design was controlling. On the basis of economic studies a distributor could determine which alternative supply could be acquired at the lowest incremental cost, and on the basis of such studies a decision was made to either install peak-shaving capacity or to contract for additional gas supply from his pipeline supplier. However, under today's circumstances where a natural gas shortage exists, the distributor is not

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[11] ***Transwestern Pipeline Company,*** Docket No. RP74-52, issued March 2, 1976 (Slip. Op. at 6); and ***Trunkline Gas Company, supra*** Note 10. The Commission therein was unpersuaded by the financial risk argument, noting that this problem can be remedied by careful estimates of future sales volumes, as well as by a new rate increase filing under Section 4 of the Natural Gas Act. In addition the Commission noted therein that the shift to the ***United*** rate design would pressure the pipelines to seek and secure the volumes of gas necessary to maintain the deliverability used in estimating sales volumes.

free to make a decision to seek additional gas supply from his pipeline supplier. Today, a distributor must attempt to serve all his customers that do not have alternative fuel capability. Thus, a distributor faced with a situation where he cannot presently serve or in the near-term future will not be able to serve all his customers' needs must seek additional supplies from sources other than contractual arrangements for additional gas supply from his pipeline supplier. These other sources would include SNG, coal gasification, Order No. 533 arrangements for qualified end-users, conventional storage and LNG from summer valley gas, other LNG arrangements, and other peak shaving. The distributor would undertake economic feasibility studies, environmental studies, siting studies, and studies on the availability of various feed-stocks. From these studies the distributor would make a determination as to the most viable alternative fuel source. We cannot see any reason for the distributor taking into consideration whether his pipeline supplier's rate is based on the *Seaboard* formula or the *United* formula. We therefore find that a decision on our part to adopt the *United* formula of rate design should not have any appreciable effect on a distributor making a decision to invest in peak-shaving facilities.

Finally the Judge concluded there were more direct and effective methods for achieving the goals which this rate design proposal (United) attempts to achieve indirectly; i.e., Transco's demand charge adjustment and end-use rates. We view demand charge adjustments and their subsequent recoupment through a commodity surcharge as a method of giving effect to the pipeline company's inability to meet contract commitments on individual days due to lack of sufficient gas supply while at the same time permitting the pipeline company to recoup that portion of its fixed costs included in its demand charges. We have stated on several occasions that pipeline companies should be permitted to recover those fixed costs included in their demand charges. We do not view this issue as providing us with

an effective method to achieve our goals because, with the exception of approving the tariff provision, we simply do not have control over the level of the commodity surcharge. Its level is controlled by the weather, Transco's gas supply, and other circumstances. The commodity surcharge is continually changing from adjustment date to adjustment date and we do not believe its level provides us with the necessary direct control of the proper rate design.

We view end-use rates as a possible future step in our efforts to price gas more effectively in order to encourage conservation and discourage low priority use. However, we are not prepared at this stage to say if and when such approach may be adopted. Meanwhile we are faced with a declining gas supply accompanied by an increasing amount of excess pipeline capacity. The question of who should bear the cost burden must be addressed now rather than later.

On the basis of the above discussion we find there is no bar to a determination on our part to adopt a *United* rate design for Transco. Thus, if we were to adopt a *United* rate design rather than a *Seaboard* rate design, costs would be shifted from low-load factor distributors to high-load factor distributors. In *United* we determined that the annual use of the system was more important than peak usage and we found that customers that made greater annual use of the system should bear a heavier burden than they had in the past in contributing revenues toward recovery of *United's* cost of service. In the case of Transco, we believe that high-load factor distributors should also be required to shoulder a heavier burden toward recovering Transco's cost of service because they make greater annual use of Transco's system even though the increased costs may fall upon the same class of consumer. Therefore, we shall adopt the *United* rate design for Transco's system.

III. *Advance Payments*

As of the end of the adjusted test period in RP75-3, that is January 31, 1975, Transco had made advance payments

amounting to $15,006,250 which it has sought to include in rate base for the first time.[12] All of these advance payments were made pursuant to Order No. 499,[13] except for a portion of those made to Occidental, which are governed by Order No. 465.[14]

The Administrative Law Judge allowed Transco to include in rate base $11,665,654 of the $15,006,250 in advance payments claimed. He treated the advance governed by Order No. 465 separately from those governed by Order No. 499.

Concerning the $6,659,106 front-end or lump sum advance payment made under the August 10, 1973, contract between Transco and Occidental, which is governed by Order No. 465, he ruled preliminarily that Staff's 30 day installment rule (only advance payments actually .expended by the producer within 30 days of the end of the test period) must find support, if at all, from the "reasonable and appropriate" criterion enunciated in Order No. 465, and not from Order No. 499 or post-Order No. 465 Commission orders. He permitted the inclusion of this entire $6,659,106 front-end advance payment to Occidental in rate base upon a finding that this transaction was the product of "sound

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[12]

Advance to	*Amount*
Occidental Petroleum Corporation and Canadian Occidental of California, Inc. (Occidental)	$ 9,000,000
Cities Service Oil Company (Cities)	$ 2,331,625
Skelly Oil Company (Skelly)	$ 2,331,625
Getty Oil Company (Getty)	$ 1,343,000

[13] 50 FPC 2111 (1973).

[14] 48 FPC 1550 (1972).

business judgment" and that Transco "did about as well as could be expected" in light of producers' superior bargaining power. He also found precedent rejecting Staff's proposed time stricture on Order No. 465 advance payments.[15]

Concerning the remaining $8,347,144 of advance payments to Occidental, Cities, Skelly and Getty under Order No. 499, the Administrative Law Judge found definite Commission intention in that order to impose a strict time requirement between the making of the advance payment by the pipeline and its expenditure for exploration, development and production by the recipient producer. He then limited Transco's rate base entitlement to those Order No. 499 advances actually expended by the respective producers by the end of the test period: $1,727,000 for the Cities advance payment, $1,727,000 for the Skelly advance payment, $787,000 for the Getty advance payment, and $765,548 for the remaining Occidental advance payment. He found that Transco's proposed rate base treatment for those advance payments not expended by the producers before the end of the test period violates the ratemaking precept that only expenditures for "used and useful" facilities can be included in rate base, as well as the basic Commission advance payment objective. In this connection he noted Commission precedent espousing this same strict timing standard.[16] He imposed a "line-of-credit financing" test by which there can

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[15] *Columbia Gas Transmission Corporation (Getty)* Opinion No. 722, Docket Nos. RP71-8, *et al.* issued March 7, 1975; *Michigan Wisconsin Pipe Line Company*, Docket Nos. RP73-102, *et al.*, initial decision issued March 31, 1975; *Tennessee Gas Pipe Line Corporation* Docket No. RP73-113, initial decision issued February 3, 1975; and *Trunkline Gas Company*, Docket Nos. RP72-23, *et al.*, initial decision issued November 13, 1974.

[16] *Natural Gas Pipe Line Company of America*, Docket No. RP 73-110, issued September 4, 1974. (The Commission expressed its intent that advance payments resemble a line of credit, being drawn down as cost and progress dictate).

be no time lag between the payment of the advance to the producer and the producer's expenditure of the advance. Accordingly, he rejected Staff's 30 day installment rule. In this regard he rejected Staff's further argument that, notwithstanding the 30 day installment rule, Transco's Order No. 499 advance payment to Occidental should go into rate base because it contains a repayment clause the benefit of which to the ratepayers outweighs the financial detriment of the front-end nature of the advances: He reasoned that Order No. 499 established an absolute time stricture which cannot be avoided by a balancing of benefits and detriments. In addition he was not persuaded by Transco's contention that it had negotiated in good faith under the circumstances, finding that the producers' insistence on front-end advance payments is irrelevant in the fact of the Commission's express temporal restriction in Order No. 499 which cannot be ignored in light of market pressures. Finally, the Administrative Law Judge refused Transco's argument of retroactive ratemaking by adjudication, noting that the choice between rulemaking and adjudication is vested in the agency's discretion.

As a collateral matter the Administrative Law Judge adopted Staff's proposal to attach a refund condition to the Commission's inclusion of portions of Cities', Skelly's and Getty's advance payments to protect Transco's ratepayers against the reservation clause in these three contracts (these three producers have reserved up to one-third of the gas to flow from the acreage under these advances for use in their own plants or facilities). He did, however, reject Transco's proposed offset from these refunds for carrying charges on these advances resulting from regulatory lag: He found that regulatory lag is considered only in establishing a return on common equity.

Staff does not except to the result reached in the initial decision as to the Order No. 499 advance payments to Cities, Skelly and Getty, noting that the amount of ad-

vances allowed into rate base is the same as its recommendation, but it does except to the underlying reasoning; that is, Staff contests the Administrative Law Judge's reading of "line-of-credit financing" by which no time lag is permitted, noting that such a rule would require the producers to have adequate capital on hand before the advances were made, a situation at odds with the Commission's objective of capital formation. Staff contends that its 30 day rule is consistent with the Commission's objective underlying the advance payment program.

Staff then reiterates its theoretical imposition of the 30 day rule upon Transco's Order No. 465 advance to Occidental and excepts to the Administrative Law Judge's ruling that the Commission is precluded from imposing a specific time limit on Order No. 465 advance payments. It finds an undue burden upon Transco's ratepayers arising from the per se inclusion in rate base of this $6,659,106 front-end advance of Occidental in that as of March 1, 1975, Occidental had only expended $1,519,687 of this amount, and it would cite Commission precedent [17] supporting imposing of timing restrictions upon Order No. 465 advances. Notwithstanding these arguments, however, Staff continues to support inclusion of all $9,000,000 of Transco's advance payments to Occidental on the grounds that the repayment provision contained in the November 7, 1974, amendment of the Transco-Occidental advance payment contract should result in less carrying charges paid by Transco's ratepayers than would occur under the 30 day rule.[18] Concerning the Order No. 499 portion of the Occidental advance, Staff asserts out of fairness to Transco that the Commission should not apply the timing re-

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[17] *Texas Eastern Transmission Corporation,* Docket No. RP74-41, issued September 17, 1975 (Slip. Op. at 9).

[18] Under this new repayment provision Occidental must repay all advances to Transco within five years of the first production of any block, instead of repayment on a block by block basis.

striction found in Order No. 499 absolutely if and when, as herein, the pipeline has been able to obtain even more favorable terms despite the front-end nature of the advance. Staff would, however, have the Commission impose a condition requiring the refund of any carrying charges in excess of those that would have been paid by the ratepayers under the 30 day installment test.

In excepting to the initial decision Transco first of all attempts to refute the no time-lag rationale employed to reduce the allowable portion of the Order No. 499 advances to Occidental, Cities, Skelly and Getty from $8,347,144 to $5,006,548 by arguing that this reduction violates the ratemaking precept that a pipeline should be allowed to earn a fair return on capital investment prudently made. Transco then argues that the Commission should find that all the advance payments were prudently and in good faith made, pointing both to the record and to certain statements in the initial decision (p. 30). It furthermore contends that the Administrative Law Judge's blanket no time-lag rule conflicts with the Commission's express intention to consider the reasonableness of advances on a *case-by-case* basis. In this regard Transco points to the advantages accruing to its ratepayers from the 1974 amended Occidental advance payment agreement, to-wit: the improved repayment provision, *supra* note 18, and improved front-end timing by which further advances would be made only one year in advance. (Tr. 533, 538-539). Transco would reinforce the prudency of its front-end advance payments by reemphasizing the competitive market pressures then extant. It furthermore reiterates its argument that imposition of this rigid time standard is retroactive ratemaking in violation of Due Process, notwithstanding the Commission's discretion in choosing rulemaking or adjudication.

As a collateral matter while Transco does not oppose the refund condition relative to the producer "reservation" clauses, it does reassert its regulatory-lag offset proposal.

We find that the initial decision should be affirmed in part and reversed in part on the issue of advance payments. Specifically, while the $6,659,106 front-end advance made to Occidental and governed by Order No. 465 should be included in Transco's rate base, as was done in the initial decision, we do so for a different reason. In addition this new rationale should also be employed to include in rate base the $2,340,894 front-end advance made to Occidental and governed by Order No. 499, as compared to the $765,548 allowed in the initial decision. Finally, although only $4,241,000 of the $6,006,250 advance payments made to Cities, Skelly and Getty, should be included in Transco's rate base, as in the initial decision, the strict no time-lag test employed therein is rejected.

Concerning the $9,000,000 advance payment to Occidental, the portion governed by Order No. 465 should be included in rate because it is "reasonable and appropriate." The Commission has noted the issue of time between the making of advance payments by the pipeline and the actual expenditure by the producer.[19] The Commission must be convinced by Transco that the agreement benefits the ratepayer. The record evidence in this proceeding (Tr. 600-602; Exhibit 41, Schedule 2) indicates that, while the ad-

[19] *Columbia Gas Transmission, supra* 15, slip. Op. at 8 ("We agree with the Staff that there must be a reasonable and appropriate relationship between the amount and time of advance and the amount and time of their utilization." This was in the context of Order No. 441); *Natural Gas Pipe Line, supra* note 17, slip op. at 6 ("Our intent has been that the actual advance of funds would closely approximate the operation of a line-of-credit i.e., the funds would be drawn down as cost and progress required." This was in the context of Order No. 465); and Order No. 499, *supra* note 14 ("Moreover, as a general policy, we shall not consider amounts advanced to be 'reasonable and appropriate' for inclusion in rate base where such amounts are in excess of costs for exploration, development and production incurred by the producer within a reasonable time from the date such amounts advanced are included in the pipeline's rate base.")

vance payments to Occidental had not been substantially expended by the end of the test period (Occidental had expended only $2,285,234 of the $9,000,000), the amended repayment provision, *supra* note 18, could well save the ratepayer more in advance payment carrying charges than would be saved by insisting upon Staff's 30 day installment rule or the Administrative Law Judge's "line-of credit financing" rule. In addition under the November 1974 contract amendment additional payments by Transco to Occidental were to be made no more than one year in advance of Occidental's expenditure (Tr. 533). This is a change from the original agreement providing for completely front-end advances. Of course to the extent that subsequent *actual* Occidental costs and first production dates change so as to nullify this projected cost saving, Transco will be required to refund any carrying charges collected in excess of the carrying charges that would have been paid if the advances had been made on a monthly installment basis. While the Commission has been much more explicit in Order No. 499 than in Order No. 465 concerning the timing between payment and expenditure of the advance so as to mandate more stringent scrutiny of this aspect of Order No. 499 advances, the Order No. 499 portion of the Occidental advance payment should be included in rate base for the same reason detailed above.

Our inclusion in rate base of these Order Nos. 465 and 499 advance payments to Occidental comports with our recent order treating front-end advance payments made under Order No. 465, *Tennessee Gas Pipeline Company*, Opinion No. 769, Docket No. RP73-113, issued July 9, 1976. Specifically, while we excluded substantial front-end advances therein, we stated that "if a positive benefit to the consumer can be shown, [the pipeline] is entitled to rate base treatment of these advances." (Slip op. at 32). This approach of looking at the specific advance payment agreements on a case-by-case basis to ascertain whether there is a positive benefit to the consumer is reiterated in Opinion No. 769-A, issued this day. In the instant proceeding such a "positive benefit" has been demonstrated for the Occidental advances.

The Order No. 499 advance payments to Cities, Skelly and Getty should receive rate base treatment to the extent provided in the initial decision, that is $1,727,000 out of $2,331,625 paid to Cities and to Skelly and $787,000 out of $1,343,000 paid to Getty. Although it should be noted that under these three agreements Transco would make continuing advance payments to these producers semi-annually based upon producer expenditure estimates for the next six months (Tr. 531), this attempt by Transco to conform to the timing requirement of Order No. 499 is not convincing. Transco did not meet its burden of proof, and accordingly, it should be limited to rate base inclusion of those advances actually expended by Cities, Skelly and Getty within one month after the close of the adjusted test period. This absence of a showing of compensating benefit of the ratepayer to outweigh the absence of a close time relationship in the case of these three advance payments is contrasted to the successful showing of benefit in the advance payment to Occidental.

Finally, placement upon Transco in the initial decision of a refund condition to account for any exercise of the reservation options in the agreements with Cities, Skelly and Getty should be affirmed. This is necessary to protect the interest of the ratepayers and follows Commission precedent.[20] Transco's suggested regulatory lag offset was likewise correctly denied.

In conclusion, of the total $15,006,250 of advance payments sought by Transco to be included in rate base $13,241,000 should be put into rate base.

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[20] *Columbia Gas Transmission Corporation, supra* note 15. (Slip Op. at 9).

IV. *Demand Charge Adjustment and Storage Injection Rate*

Although the settlement of these two dockets settled all issues except for the three reserved issues of unsuccessful SNG project expenditures, rate design and front-end advance payments, Brooklyn for the first time on brief to the Administrative Law Judge sought the abolition of Transco's demand charge adjustment and the establishment of a special storage injection rate which would exclude all non-storage related fixed costs. While the Administrative Law Judge noted a minimal amount of evidence on these matters introduced by Brooklyn, he summarily rejected both proposals on the ground that the other parties were not given timely notice of the issues and an opportunity to present evidence on these matters. He suggested that, if Brooklyn retained interest in these two issues, it should institute a Section 5 proceeding.

In excepting to this refusal to consider eliminating the demand charge adjustment and instituting a special storage injection rate, Brooklyn makes the argument that the reservation of the rate design issue for this adjudication necessarily includes the allegedly related issues of demand charge adjustment and storage injection rate, which also deal with the demand-commodity relationship. It then proceeds to discuss the merits of its two proposals.

Transco, Staff, New York, and Con Ed oppose Brooklyn's exception on the multiple bases of lack of notice to the other parties, absence of record evidence supporting Brooklyn's position, and the narrow scope of the reserved rate design issue (choice between the *United* and *Seaboard* formulas). Columbia and Consolidated note that they do not support Brooklyn; however, if the Commission were to retain the *United* rate design, they would then support Brooklyn's proposed special storage injection rate.

We find that the refusal in the initial decision to consider Brooklyn's two proposals should be affirmed. Section 10 of Article III of the settlement clearly establishes the

narrow scope of the rate design inquiry, and accordingly no party had reason to anticipate adjudication of Transco's demand charge adjustment and lack of a special storage injection rate, notwithstanding Brooklyn's belated attempt on brief to the Administrative Law Judge to inject these issues. Clearly the minimum standards of notice and opportunity to present evidence have not been satisfied.

V. *Miscellaneous*

In the ordering clause of the initial decision the Administrative Law Judge ordered Transco to file revised tariff sheets reflecting the changes made in the initial decision, as well as making the corresponding refunds. Transco excepts to the filing of revised tariff sheets because RP75-3 is now a "locked-in" docket. It also excepts to the refund order as it relates to rate design (the settlement stated that resolution of the rate design issue would only have prospective effect) and to advance payments (due to an advance payment tracking filing under the settlement made on July 1, 1975, these refunds should only cover the period from February 1, 1975, through June 30, 1975).

Staff opposes Transco's miscellaneous exceptions. To begin with, while it acknowledges that RP75-3 is "locked-in" by RP75-75 so as to render the RP75-3 rate no longer "effective," Staff argues that the RP75-3 tariff should be revised to reflect the resolution of the reserved issues anyway. Although Staff agrees with Transco that refunds should not be ordered concerning rate design because resolution of that reserved issue was expressly limited to prospective effect, it opposes Transco's argument against refunds concerning disallowed advance payments because the Commission has rejected Transco's advance payment tracking filings. Accordingly, Staff contends that such refunds should be ordered for the period from February 1 through October 1, 1975.

We find that ordering paragraph (a) of the initial decision, requiring the filing of revised tariff sheets, be adopted, and that ordering paragraph (b) of the initial decision, requiring refunds, should be expressly limited to the unsuccessful SNG project expenditures and the advance payments, as Staff proposes.

The Commission further finds:

(1) Applicant, Transcontinental Gas Pipe Line Corporation, is a "natural gas company" subject to the provisions of the Natural Gas Act, and the sales of natural gas subject to the order which follows as a part of this decision are sales of natural gas in interstate commerce for resale subject to the jurisdiction of the Commission.

(2) Those portions of Applicant's rates, which were not part of the settlement accepted by the Commission on November 13, 1975 and which have been in effect in these dockets subject to refund, have not been shown to be just and reasonable or otherwise lawful under the provisions of the Natural Gas Act in the respects noted above, and Applicant should be required to file revised tariff sheets encompassing just and reasonable rates as necessary to conform to this opinion and order.

(3) Applicant should be required to refund to its jurisdictional customers any amounts reflecting the difference between its proposed rates and the rates required to be filed by this opinion and order, specifically relating to unsuccessful SNG project expenditures and advance payments.

(4) The initial decision issued in this reserved issues proceeding on December 22, 1975, should be affirmed in part and reversed in part as hereinabove detailed.

(5) The unilateral offer of settlement filed by Transco on July 2, 1976, should be rejected for the reasons set forth in the body of this order.

The Commission orders:

(A) The increased rates referred to in Paragraph (2) above are disallowed to the extent that they do not conform to this opinion and order.

(B) Within 60 days of the issuance of this opinion and order Applicant shall file any necessary amendments to its cost of service, rate design and tariff sheets for the period from February 1, 1975, to October 1, 1975, relating to unsuccessful SNG project expenditures and advance payments and prospectively relating to rate design, subject to the approval of the Commission.

(C) Within 30 days of the Commission's approval of its substitute tariff sheets in accordance with paragraph (B) above, Applicant shall refund to its customers for the period of February 1, 1975, to October 1, 1975, all amounts, relating to unsuccessful SNG project expenditures and advance payments collected in excess of those which have been payable under the rates and charges approved in accordance with paragraph (B) above, together with interest at the rate of nine (9) percent per annum from the date of payment to Applicant to the date of refund.

(D) Within 30 days after making the refunds required by paragraph (C) above, Applicant shall file with the Commission in writing and under oath a report as to the amount of any refunds made and its method of computing the same, together with releases from its jurisdictional customers.

(E) The initial decision issued in this reserved issues proceeding on December 22, 1975, is affirmed in part and reversed in part as hereinabove detailed.

(F) Exceptions not granted are denied.

(G) Brooklyn's motions for oral argument and expedited decision are hereby denied.

(H) Transco's offer of settlement is hereby rejected.

By the Commission. Commissioner Holloman, dissenting, filed a separate statement appended hereto.

(SEAL)

Kenneth F. Plumb,
Secretary.

HOLLOMAN, Commissioner, *dissenting*:

I dissent to the majority opinion with respect to its treatment of certain advance payments made by Transcontinental Gas Pipeline Corporation, hereinafter referred to as Transco, and sought to be included in its rate base pursuant to Commission Order No. 465, 48 F.P.C. 1550 (1972), and Order No. 499, 50 F.P.C. 2111 (1973). While the more salient points are discussed below, the specific details of these contracts are more fully set forth in Judge Benkin's Initial Decision and in the majority opinion. However, there is no dispute as to the provisions contained in the contracts involved. The legal issues in dispute concern (1) whether any of these payments fall within the rubric of Order Nos. 465 or 499, and if so to what extent, and (2) whether the rationale for such inclusion or exclusion, as stated by the majority, is correct.

First, as to the advance payments covered by Order No. 465, all were made by Transco to Occidental pursuant to the provisions of an unamended contract executed on August 10, 1973. I concur with Judge Benkin's decision to include these payments and for the same basic reasons set forth in his initial decision, as well as for other reasons more distinctly enumerated in my dissenting opinion in *Tennessee,* Opinion No. 769-A, issued today, the same being incorporated herein by reference.

While I commend the majority opinion's decision to reject what it refers to as the Staff's 30-day installment rule in this case and hail the equitable result reached by allowing the Order 465 advances in rate base, I am constrained to dissent to the tortured rationale adopted as justification for such inclusion. The majority, obviously haunted by its basic and fundamental error in *Tennessee, supra,* reaches the right result for the wrong reasons. Rather than correct its error on rehearing in *Tennessee, supra,* the majority elected there to mitigate what Commissioner Smith termed the "traumatic" result reached

by overcompensating the pipeline with an unjust and unreasonable rate of return. In other words, the majority offered one error as a *quid pro quo* for another. Here the majority seeks to offset the "traumatic" results that would necessarily and logically follow an extension of its rationale in *Tennessee* to the facts here. It does so by adopting a new standard which it candidly refers to as this "new rationale." Essentially, this "new rationale" appears to say that the *Tennessee* rule will be suspended if collateral considerations agreed to show positive, compensating or added benefits to the ratepayer.

The majority obviously has problems in bringing the initial front-end, Order No. 465 advances, made by Transco to Occidental, within the aegis of this new rule or exception. In order to do so, it considers the initial agreement, in light of the subsequent amendments, in order to find the collateral benefits required.

The original contract covering Occidental's working interest in eleven blocks in the High Island area of Offshore Texas required an initial front-end advance of $2 million for exploration activities and an additional front-end advance of $750,000 for further exploration if gas in sufficient quantities to warrant development was discovered. In addition thereto, Transco was obligated to make a lump-sum front-end payment of Occidental's share of the development costs when 51 percent of the working interest owners agreed upon a development plan. Clearly, taking this contract on its face and applying the majority's *Tennessee rationale*, the advance payments made pursuant to its terms and conditions would not qualify for rate-base treatment under Order No. 465. In order to bring these payments within the "added benefits" exceptions, the majority reaches forward in order to envelop and incorporate the provisions of the 1974 amendments retroactively. The majority then concludes that the $9 million advance payment to Occidental under Order No. 465 could be considered "reasonable and appropriate" if the Commission is "convinced by Transco that the agreement [as amended] 'benefits' the ratepayer." The majority then finds that although only $2,285,234 of the $9 million would be eligible for inclusion under the original contract, "the amended repayment provision . . . could well save the ratepayer more in advance payment carrying charges than would be saved by insisting upon Staff's 30-day installment rule or the Administrative Law Judge's 'line-of-credit financing' rule." At this point, the majority obviously becomes confused by the complexity of its own logical machinations. Judge Benkin's initial decision does not apply a line-of-credit financing rule to the Occidental payments under Order No. 465. Nevertheless, the majority then qualifies its own exception by requiring future refunds in the event its theoretical ratepayer savings fail to materialize in fact.

While it is not my intention to belabor this aspect of the majority opinion, it provides a painful and needed insight into present and future problems which necessarily flow from the majority's opinion in *Tennessee*. In order to qualify these payments for rate base inclusion, the majority is compelled to stand both logic and the law on their heads in order to avoid the implications of the *Tennessee* decision. All of this is quite unnecessary because the plain and simple fact remains that these payments are eligible for rate base inclusion under the plainly-stated language of Order No. 465. I reiterate my concurrence with the Administrative Law Judge on this question.

The second major error contained in the majority opinion concerns the treatment of advance payments made pursuant to Order No. 499, i.e., the application of the 30-day rule as announced in Tennessee. I concur with the Administrative Law Judge's finding that this issue "presents a considerable problem." The problem results from the fact that the Commission, while indicating its concern that future advances bear some relationship to producer expenditures, did so in such vague terms as to indicate little

more than disapproval of the massive and ongoing execution of contracts providing for unlimited front-end advances. In addition to the "reasonable and appropriate criteria, Order No. 499 adds the following language:

> "Moreover, as a general policy, we shall not consider amounts advanced to be 'reasonable and appropriate' for inclusion in rate base where such amounts are in excess of costs for exploration, development, and production incurred by the producer within a reasonable time from the dates such amounts advanced are included in the pipeline's rate base."

With respect to the restrictive language quoted above, I concur with the Administrative Law Judge's finding that:

> "The teaching of that order does not easily resolve the issue, of course, because the 'reasonable time' standard *per se* is not sufficiently concrete to control the outcome of the specific cases."

I also agree with Judge Benkin that the foregoing language "does evince a deep concern about the possibility of untoward harm steming from a rate base treatment of advances which remain outstanding for *excessive periods of time.*"

Therefore, subsequent to the adoption of Order No. 499, the "reasonable and appropriate" standard must be considered in light of the "reasonable time" limitation of that order. Although I disagree with Judge Benkin's conclusions with respect to the advance payments made under Order No. 499, I cannot improve upon his statement as to the reasonable and appropriate test. In his initial decision in this case, Judge Benkin stated:

> "The standard is familiar to ratemaking and usually refers to the overall prudence of a particular transaction, weighed under a 'reasonable man' criterion. Unless it can be said that the bargain struck with Occidental was so inopportune as to represent the antithesis of sound business judgment, it is difficult, if not impossible to deny Transco the fruits of the transaction based on the thesis that the advances to Occidental were not 'reasonable and appropriate' in their totality. It clearly cannot be said that, in negotiating the first Occidental agreement, Transco acted in bad faith or failed to make the best deal possible in the circumstances. In this, as in the other, negotiations for advance payment agreements, Transco did about as well as could be expected under its view of the Commission's regulations governing those agreements. The fact that the agreements provide for heavily "front-end weighted" payments—in effect substantial, extended interest-free loans to the producers—is undoubtedly the result of the parties' unequal bargaining power. A pipeline that is heavily curtailed and in competition with other similarly situated, pipelines for an extremely limited supply of gas is hardly in a position to exact highly favorable terms from producers."

Unfortunately, although Judge Benkin's decision is right for the right reasons with respect to the advance payments made pursuant to Order No. 465, I can find no justification for the so-called line-of-credit rationale he used in disallowing advance payments made under Order No. 499. Judge Benkin begins by referring to the Staff's 30-day installment rule as "Draconian." He then chastises Staff's position for "allowing Transco to include in rate base *only* $4,241,000 . . . ." Judge Benkin describes Staff's proposal as "whole cloth in nature and inherently arbitrary" and "wholly without merit."

Having written an excellent opinion at this point, Judge Benkin errs by adopting a so-called line-of-credit test which allows "no time" between advance payments and producer expenditure. Judge Benkin believes this conclu-

sion is compelled by Order No. 499 "when construed in the light of the Commission's 'line-of-credit' announcement in its September 4, 1974, order in the *Natural* case." Natural Gas Pipeline Company of America, Docket No. RP73-110. In that order approving a settlement agreement with condition, the Commission stated:

> The stated objective of our advance payment program has been, from the outset, to increase directly the funds available for natural gas exploration, development, and production which does not mean that funds would be available for other purposes. Our intent has been that the actual advance of funds would closely approximate the operation of a line-of-credit, *i.e.*, the funds would be drawn down as cost and progress required.

Judge Benkin justifies this result by noting that the Commission is "vested by law with both rulemaking and adjudicative tools." The majority opinion likewise rests upon the idea that a rulemaking can subsequently be changed on a case-by-case consideration. As support for his theory that a Commission rule can be subsequently amended in an adjudicative proceeding, Judge Benkin quotes with approval *NLRB* v. *Bell Aerospace Co.*, 416 U.S. 267, 294 (1974). In that case, the Supreme Court stated that an agency "is not precluded from announcing new principles in an adjudicative proceeding and . . . the *choice* between rulemaking and adjudication lies in the first instance withing the [agency's] discretion." Judge Benkin overlooks the clear admonition in the foregoing language that an agency has the *"choice"* between rulemaking and adjudication. It is well-settled as a principle of administrative law that an agency of the government, having elected to adopt a standard of general applicability by rulemaking may not alter, change or amend that rule by a subsequent pronouncement in an adjudicative proceeding. Thus, in *Arizona Grocery* v. *Atchison Railway*, 284 U.S. 370, 389 (1923), the Court admonished the I.C.C. as follows:

> "As respects its future conduct the carrier is entitled to rely upon the declaration as to what will be a lawful, that, is, a reasonable, rate; and if the order merely sets limits it is entitled to protection if it fixes a rate which falls within them. Where, as in this case, the Commission has made an order having a dual aspect, it may not in a subsequent proceeding, acting in its quasi-judicial capacity, ignore its own pronouncement promulgated in its quasi-legislative capacity and retroactively repeal its own enactment as to the reasonableness of the rate it has prescribed."

While this is simply a statement of a fundamental principal of administrative law settled long ago, I would also note *Service* v. *Dulles*, 354 U.S. 363 (1957); *U.S. ex rel. Accardi* v. *Shaughnessy*, 347 U.S. 260 (1954); *NLRB* v. *Majestic Weaving Company*, 355 F.2d 854 (2d. Cir. 1966); and *Public Service Commission of New York* v. *F.P.C.*, 295 F.2d 140 (D.C. Cir. 1961), *cert. denied*, 368 U.S. 948. If the Commission believed that the rule enunciated in Order No. 499 was inadequate to apprise the public of its intent, the proper and only course was an amendment to the rule itself.

However, even accepting Judge Benkin's notion that Order No. 499 should be read in light of the subsequent *Natural* case, I concur with the Public Service Commission of the State of New York that the language contained therein is too vague and uncertain as to give any useful guidance in the determination in this case.

I therefore find that Transco responded to Order No. 499 in a reasonable and prudent manner considering all of the facts and circumstances involved. Negotiation of

advance payment agreements providing for unlimited front-end advances, as was admittedly the "name of the game" under Order No. 465, were discontinued. Although the agreement with Occidental provided for annual advances, it also contained what the majority admits as an "amended repayment provision" which "could well save the ratepayer more in advance payment carrying charges than would be saved by insisting upon Staff's 30-day installment rule or the Administrative Law Judge's 'line-of-credit financing' rule." In addition, Transco insisted upon and obtained producer agreement to apply this "new benefit" retroactively to those advances previously made under Order No. 465. With respect to the agreements with Cities, Skelly and Getty, the previous front-end advances were rejected in favor of semiannual advances. Clearly, when considered in light of Order No. 499 and applying Judge Benkin's own "reasonable and appropriate" standard, articulated on page 30 of his opinion, all of these payments should be included in Transco's rate base. To the extent they are denied, Judge Benkin and the majority have found it necessary in this case to invent and apply retroactively, *post hoc* schemes and theories which have no rhyme or reason to them; which stand the law, logic and equity on their heads and defy every accepted principle of reasoned decision-making.

In retrospect, it is clear that the advance payment program was probably ill-conceived from its inception to its termination. As an experimental program, it's vaguely-stated provisions can only be viewed as intended to give a free reign to the pipelines and producers in fashioning these contracts to attain the results desired. As the D.C. Circuit has recently stated in *United Gas Pipeline Company* v. *F.P.C.*, D.C. Cir. Nos. 75-1943 and 75-2051, issued February 24, 1977:

> "The Commission, of course, should view the Agreements in the context of the time which produced them

> —a time of severe natural gas shortage when experimental programs fashioned to alleviate this problem were being implemented. A too restrictive view of alternate methods of meeting this crisis, advanced by parties other than the Commission, certainly would not be in the public interest."

As further stated by the D.C. Circuit in *United, supra*:

> "Secondly, and perhaps more importantly, we have found nothing in the Commission's orders setting up the advance payment program to indicate that the producers who were given such payments had to demonstrate an actual need for them. It is apparent that the Commission instituted the advance payment program merely as a means to enhance significantly the supply of natural gas in the interstate system during a period of critical nationwide gas shortages. It declared that the program was expected to intensify the development of new sources of natural gas supplies, and thus alleviate the supply shortage, but it never expressly mandated that a producer show that but for the advance payments it would not be able to obtain the necessary exploration and development capital. We think it unreasonable for the Commission now to adopt such a standard for United's interest reimbursement arrangements when they apparently constitute an alternative means of attaining the same goal as the Commission's own advance payment program.

This program was set in motion on October 2, 1970, with the Commission's adoption of Order No. 410. It was under constant review and reconsideration from that time until its termination on December 31, 1975. In 1971, the Commission's review and reconsideration of this program resulted in the issuance of FPC Order No. 441. In 1972, the Commission's review and reconsideration of this program resulted in the issuance of Order No. 465. In 1973, the

Commission's review and reconsideration of this program resulted in issuance of Order No. 499. Furthermore, in its order terminating this program, the Commission thoroughly reviewed the entire program and concluded that the same should be terminated prospectively and phased-out as directed in that order. From its inception to its termination, this Commission had the option at numerous states, to change, alter or condition this program in any manner it desired. The Commission cannot now do indirectly that which it has declined throughout this period to do directly. This Commission cannot now do retrospectively what it declined to do prospectively at any time from 1970 through 1975. Therefore, to the extent any of these advance payments made under Order No. 465 or 499 are excluded from rate base by this opinion, I dissent. Furthermore, to the extent these advances are included by the majority opinion, I dissent to their rationale for doing so.

/s/ JOHN H. HOLLOMAN III
John H. Holloman III
Commissioner

APPENDIX D

UNITED STATES OF AMERICA
FEDERAL POWER COMMISSION

Opinion No. 801-A

Docket Nos. RP74-48 and RP75-3

TRANSCONTINENTAL GAS PIPE LINE CORPORATION

OPINION AND ORDER DENYING REHEARING IN MOST RESPECTS OF OPINION AND ORDER ESTABLISHING JUST AND REASONABLE PIPELINE RATES

(Issued: July 29, 1977)

Before Commissioners: Richard L. Dunham, Chairman, Don S. Smith, and John H. Holloman III.

Presently before the Commission is an application for rehearing of Opinion No. 801. We deny rehearing in all respects except as to the refund condition.

On May 31, 1977, the Commission issued in this proceeding Opinion No. 801, which resolved several reserved pipeline rate issues which had not previously been settled from two rate increases filed by Transcontinental Gas Pipe Line Corporation (Transco) in Docket Nos. RP74-48 and RP 75-3. Specifically, the Commission rejected rate base and cost of service treatment for unsuccessful synthetic natural gas (SNG) project expenditures, both as originally proposed by Transco and as subsequently modified in its unilateral offer of settlement. Moreover, the Commission excluded from rate base a portion of the advance payments made by Transco to several gas producers. Finally, the Commission adopted the *United* rate design method for the Transco system.

On June 30, 1977, Transco applied for rehearing of the first two of these rulings, that is, expenditures for unsuccessful SNG projects and advance payments, but not as to

rate design. Transco also sought rehearing as regards refunds and oral argument.

Also on June 30, 1977, Tennessee Gas Pipeline (Tennessee) petitioned the Commission for leave to intervene out of time so as to apply for rehearing of Opinion No. 801, which it did at the same time. Its rehearing goes solely to the exclusion from Transco's rate base of certain advance payments made under Order No. 499, 50 FPC 2111 (1973).

Tennessee has not advanced sufficient reasons for the Commission to find good cause to permit intervention out of time. In the first place Tennessee's petition does not indicate that it has "an interest which may be directly affected," as is required by Section 1.8(b)(2) of our Rules of Practice and Procedure. Moreover, any interest which Tennessee conceivably has in this case is adequately represented by Transco, which has sought rehearing of the very issue which concerns Tennessee. Tennessee's only interest in this proceeding relates to possible precedential impact flowing therefrom. We have already held that a desire to shape precedent does not by itself afford a basis for intervention,[1] and this is especially true when late intervention is sought. While it is clear from both Opinion No. 801 and the instant order that our rate base exclusion of certain advance payments was founded upon a review of the specific facts in this case and not a *per se* application of a "30 day rule", as claimed by Tennessee, we shall nonetheless entertain Tennessee's arguments on rehearing and shall construe Tennessee's application for rehearing as an application for reconsideration *amicus curiae*.[2]

[1] *Permian Basin Area Rate Proceeding*, 26 FPC 193, 194 (1961).

[2] *See, Permian Basin Area Rate Proceeding*, 32 FPC 1382 (1964).

1) Expenditures for Unsuccessful SNG Projects

We deny Transco's application for rehearing concerning its SNG project expenditures, rejecting all of its many legal arguments, which we shall consider *seriatim*.

Transco first argues that the Commission's denial of rate base and cost of service treatment for unsuccessful SNG project costs contravenes the "prudent investment" test, which applies to the Commission, Transco asserting that these SNG costs are "admittedly prudent."

No one can argue with the proposition that the Commission espouses the "prudent investment" concept of rate base valuation. However, even if these SNG project expenditures are assumed to be prudent, rate base inclusion or even Transco's settlement proposal of only cost of service amortization is not necessarily mandated. Part and parcel of the "prudent investment" theory is the "used and useful" requirement; that is, only prudent investment for utility property which is used and useful to provide service to the utility's customers should be compensated. To say the least, the "used and useful" criterion should not take Transco by surprise, and it would be disingenuous to argue that the SNG studies and coal options for abandoned projects involved herein are "used and useful."[3] While the Commission has, after long and careful deliberation, used a more liberal interpretation of "used and useful" in specific situations,[3] such is not the present case.

Transco then advances the pro forma appellate challenges of no "reasoned decisionmaking" and arbitrary and capricious establishment of a new standard, although it does not explain how the Commission has acted so badly.

Perusal of pages 5-8 of Opinion 801 should demonstrate that we fully articulated the reasons for our decision.

[3] *e.g.* Advance payment, construction work in progress, and research and development rulemakings.

Moreover, as discussed above, the standard which Transco failed to satisfy, "used and useful," is not arbitrary and capricious.

Transco proceeds to argue that Opinion No. 801 is contrary to prior Commission policy permitting the recovery of unsuccessful projects designed for systemwide benefit, and that, since the Commission herein retroactively changed that policy, it has been denied due process.

Transco has not been denied due process by Opinion No. 801. In the first place the Commission's decisions [4] cited by Transco are clearly distinguished from the instant proceeding, as we found in Opinion No. 801. Moreover, assuming arguendo that the Commission had through adjudicatory decisions developed a policy of allowing recovery of unsuccessful project costs, application of a changed policy in a current adjudication is not necessarily proscribed by due process.[5]

Transco next argues that, if the Commission relied in its decision upon Opinion No. 624,[6] such reliance is erroneous.

Apart from the fact that Transco's complete lack of explanation for this assertion warrants no serious consideration by the Commission, we nonetheless point out that at page 6 of Opinion No. 801 we stated in no uncertain terms that reliance upon Opinion No. 624 "is not completely warranted."

Transco furthermore assails the Commission's reliance upon Opinion Nos. 728 and 728-A. It interprets those decisions as supporting recovery of these SNG project costs.

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[4] *Southern Natural Gas Company*, 29 FPC 323 (1963); *Midwestern Gas Transmission Company, et al.*, 32 FPC 993 (1964).

[5] *e.g., Retail, Wholesale and Department Store Union* v. *N.L.R.B.*, 466 F.2d 380 (D.C. Cir. 1972).

[6] *Tennessee Gas Pipeline Company*, 48 FPC 149 (1972).

Again Transco has failed to provide more than bold assertions. In any event we acted properly in considering the precedent of Opinion No. 728.[7] In Opinion No. 801 we recognized that there are obvious differences between Opinion No. 728 and Transco's proposal, and yet we also realized that our rejection of a full cost of service tariff for an SNG project in Opinion No. 728 establishes Commission regulatory policy which is appropriately applied to the instant case. This policy is, of course, that SNG expenditures which do not qualify as R & D can be recovered, if at all, only through the price paid for actual SNG production sold in interstate commerce.

Transco adds that it was error to consider the fact that SNG is nonjurisdictional until commingled with natural gas in interstate commerce. In support it asserts that the record demonstrates that it had never intended to treat these projects as unregulated. Transco adds that the Commission should not have equated the risk of these SNG projects to that of independent producers.

Again Transco states no basis for rehearing. The fact that a pipeline does not actually intend to sell SNG in intrastate, instead of interstate, commerce does not alter the need for the Commission to apply the very strict standards stated in Opinion No. 801 to every attempt to recover the costs of SNG projects. Furthermore, our analogy to the shareholder risk attendant the production activities of independent producers is merely illustrative and not the dispositive finding in our overall decision.

Finally, Transco questions whether the Commission considered its unilateral offer of settlement on its merits.

Scrutiny of pages 7 and 8 of Opinion No. 801 reveal that in fact the Commission rejected this offer of settlement only after assessing it on its merits. Transco's willingness

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[7] *Transwestern Coal Gasification Company*, Opinion No. 728, Docket No. CP73-211; issued April 21, 1975.

in this offer of settlement to abandon rate base treatment for all four unsuccessful SNG projects and even cost of service amortization for its nephtha gasification project does not benefit its customers so as to offset the previously established reasons for denying any recovery of such unsuccessful SNG project expenditures.

2) Advance Payments

In Opinion No. 801 the Commission allowed rate base inclusion for the following advance payments: the entire $9,000,000 advance to Occidental Petroleum ($6,659,106 governed by Order No. 465, 48 FPC 1550 (1972), and $2,340,894 governed by Order No. 499); and $4,241,000 out of $6,006,250 of advances to Cities Service Oil, Skelly Oil and Getty Oil (all governed by Order No. 499). Transco now seeks rehearing of the exclusion from rate base of the $1,765,250 of Order No. 499 advances made to Cities Service, Skelly and Getty. We deny rehearing in all respects.

Alleging that these advances were reasonable and appropriate, Transco assigns error to their rate base exclusion in Opinion No. 801. In support thereof it asserts that there is uncontraverted evidence that Transco acted in good faith and obtained the best possible terms under the circumstances. Transco characterizes Opinion No. 801 as arbitrary and capricious for disallowing prudent investment and as unsupported by substantial evidence. It moreover claims violation of its due process rights by the Commission's retroactive application of the new timing standard, which it views as too vague and imprecise.

In denying Transco's application for rehearing we first reject its contention that the excluded advance payments were prudently incurred. Prudency is not determined solely by the presence or absence of a good faith bargain. In Order No. 499 we expressly stated that, to be included in rate base, advances had to be expended by the recipient "producer within a reasonable time from the date such

amounts advanced are included in the pipeline's rate base." Evidence introduced by Staff indicated that the advance payments at issue were not expended within a "reasonable time" and Transco did not successfully rebut this evidence. This timing standard predates Transco's advance payments to Skelly, Getty and Cities Service; thus, there is no retroactive application. Nor is this standard too imprecise.

While Transco argues that it could not have obtained better terms from these producers in light of the competitive conditions at that time, this does not establish prudency of investment. In that the advance payment program extended the "used and useful" doctrine to its broadest possible meaning, with pipelines making interest free loans with the consumers' capital, participating pipelines had a public utility burden of providing adequate protection to those consumers. If the producers as a class ignored the reasonable timing standard set by the Commission, it was incumbent upon the pipelines to apprise the Commission of this fact, not to merely acquiesce to the hard bargains struck by the producers.

Tennessee likewise challenges our exclusion of the unexpended front-end advance payments made under Order No. 499. It first argues that Order No. 499 did not set any specific timing standard other than one of reasonableness. It points to the order on reconsideration of Order No. 499, 51 FPC 818, for the Commission's intention to treat the timing issue on a case by case basis.

We do not refute what Tennessee says, but we do reiterate that the record in this case supports the exclusion of advances made to but not expended by the producers within 30 days of the end of the adjusted test period.

Tennessee next reads precedent cited in Opinion No. 801 as not supporting what it calls the "30-day line of credit test."

In the first place such Commission precedent[8] does evince the Commission's commitment to enforce a reasonable timing relationship between when the advance is made and when it is expended, including in *Natural Gas Pipe Line* a "line of credit" approach. Tennessee's reordering of Opinion No. 722 does not comport with that made in Opinion No. 769-A,[9] which we incorporate herein. Secondly, in Opinion No. 801 we cited these decisions, *supra* note 8, as prior Commission proclamations of its intention to draw a timing relationship, but not as espousal of any specific timing interval. As noted above, we left that to each case.

Tennessee next argues that the Commission has erred by adopting Staff's 30 day rule as an irrebutable presumption, noting that the Commission has subsequently adopted this same 30 day rule in other cases. It also seeks to justify Transco's failure to rebut Staff's case, which it attacks as not supported by substantial evidence.

As we more fully explained in Opinion No. 769-A, *supra* note 9, we have not established an irrebuttable presumption, noting that the Commission has subsequently adopted this same 30 day rule in other cases. It also seeks to justify Transco's failure to rebut Staff's case, which it attacks as not supported by substantial evidence.

As we more fully explained in Opinion No. 769-A, *supra* note 9, we have not established an irrebuttable presumption. Transco does, however, have a heavy burden of proof, which it did not satisfy: Apart from the burden of proof being imposed upon Transco by Section 4(e) of the Natural

[8] *Natural Gas Pipe Line Company of America*, Docket No. RP 73-110, issued September 4, 1974; and *Columbia Gas Transmission Corporation* (Getty), Opinion No. 722, Docket No. RP71-8, *et al.*, issued March 7, 1975.

[9] *Tennessee Gas Pipe Line Corporation*, Opinion No. 769-A, Docket No. RP73-113, issued May 31, 1977.

Gas Act, it also was faced with the previously considered timing policy expressed in Order No. 499. In this context Staff's evidence made a well pleaded case for a 30 day rule in this case. To excuse Transco from adequately responding in rebuttal to this case would indeed improperly shift the burden of proof.

Tennessee adds that Staff's timing theory, adopted in Opinion No. 801, is legally erroneous for it considers the producers' need for funds, not the pipelines' need for new gas supplies.

Tennessee has again failed to advance a cogent challenge to Opinion No. 801. It is not enough for Transco to show that it needed more gas and that its advance payments succeeded in this regard. As we stated in Opinion No. 769-A, we would have been flexible in entertaining evidence as to reasonable financing practices from the perspective of either producer or pipeline. Transco refused to submit any evidence in this regard, and by therefore excluding certain front-end advance payments we did not run afoul of *United Gas Pipe Line Company* v. *FPC*, 551 F.2d 461 (D.C. Cir., 1977): Transco had a full opportunity to be heard and was on notice that the reasonableness of its front-end advances had been challenged. This is legally distinguishable from the summary disposition of the interest reimbursement arrangement in *United*.

Tennessee concludes by raising the specter of retroactivity. We reject this argument on the grounds stated above in rejecting Transco's application for rehearing.

3) Miscellaneous

Transco reasserts on rehearing its prior request for oral argument. In Opinion No. 801 we inadvertently failed to specifically reject Transco's request for oral argument, but we now reject it. No purpose would be served by granting oral argument.

In addition Transco seeks rehearing of the effective period of the rates for which refunds are ordered, that being February 1, 1975, to October 1, 1975. Transco argues that the proper refund period should be February 1, 1975, to July 1, 1975, because as of July 1, 1975, it had in effect advance payment trackers.

We do grant rehearing in this regard. While we had originally rejected these advance payment trackers by our order of January 30, 1976, in these same dockets, we subsequently granted rehearing of that order on March 26, 1976, and permitted those trackers to become effective as of July 1, 1975, subject to further adjudication in Docket Nos. RP74-48 and RP75-3 (AP76-1). Accordingly, refunds related to advance payments should be made for the period from February 1, 1975, to July 1, 1975.

The Commission further orders:

The assignments of error and grounds for rehearing set forth in Transco's application for rehearing of Opinion No. 801 (and Tennessee's application for reconsideration *amicus curiae*) present no facts or legal principles that would warrant any change in or modification of the Commission's Opinion No. 801, except concerning the refund period.

The Commission orders:

(A) The application for rehearing filed by Transco and the application for reconsideration *amici curiae* are hereby denied, except to the extent that ordering paragraphs (B) and (C) of Opinion 801 are amended to include a refund period from February 1, 1975, to July 1, 1975, relative to advance payment exclusion.

(B) Good cause has not been shown to grant Transco's request for oral argument.

(C) Transco's July 8, 1977, request for an extension of time within which to comply with ordering paragraph (B) of Opinion 801 is denied to the extent that it requests 60 days from the issuance of the instant order; however, Transco shall comply with ordering paragraph (B) within 15 days of the date of issuance of this order.

By the Commission. Commissioner Holloman, dissenting, filed a separate statement appended hereto.

(SEAL)

Lois D. Cashell,
Acting Secretary.

(Issued July 29, 1977)

HOLLOMAN, Commissioner, *dissenting*:

For the reasons articulated in my dissents to Opinion No. 801 in the above referenced dockets, I must also dissent to my colleagues continued exclusion from rate base of advance payments made by Transcontinental Gas Pipe Line Corporation to Cities Service, Skelly and Getty. I reiterate that the Commission cannot at this late date do retrospectively that which it declined to do prospectively at any time from 1970 through 1975. Consequently, to the extent that these advance payments are included in rate base by the majority, I continue to dissent to their rationale for doing so.

/s/ JOHN H. HOLLOMAN III
John H. Holloman III
Commissioner

APPENDIX E

The Natural Gas Act, 15 U.S.C. §§ 717-717w, provides in pertinent part:

SEC. 4. (a) All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and any such rate or charge that is not just and reasonable is hereby declared to be unlawful.

* * *

(e) Whenever any such new schedule is filed the Commission shall have authority, either upon complaint of any State, municipality, State commission, or gas distributing company or upon its own initiative without complaint, at once, and if it so orders, without answer or formal pleading by the natural-gas company, but upon reasonable notice, to enter upon a hearing concerning the lawfulness of such rate, charge, classification, or service; and, pending such hearing and the decision thereon, the Commission, upon filing with such schedules and delivering to the natural-gas company affected thereby a statement in writing of its reasons for such suspension, may suspend the operation of such schedule and defer the use of such rate, charge, classification, or service, but not for a longer period than five months beyond the time when it would otherwise go into effect, and after full hearings, either completed before or after the rate, charge, classification, or service goes into effect; the Commission may make such orders with reference thereto as would be proper in a proceeding initiated after it had become effective. If the proceeding has not been concluded and an order made at the expiration of the suspension period, on motion of the natural-gas company making the filing, the proposed

change of rate, charge, classification, or service shall go into effect. Where increased rates or charges are thus made effective, the Commission may, by order, require the natural-gas company to furnish a bond, to be approved by the Commission, to refund any amounts ordered by the Commission, to keep accurate accounts in detail of all amounts received by reason of such increase, specifying by whom and in whose behalf such amounts were paid, and, upon completion of the hearing and decision, to order such natural-gas company to refund, with interest, the portion of such increased rates or charges by its decision found not justified. At any hearing involving a rate or charge sought to be increased, the burden of proof to show that the increased rate or charge is just and reasonable shall be upon the natural-gas company, and the Commission shall give to the hearing and decision of such questions preference over other questions pending before it and decide the same as speedily as possible. [52 Stat. 822 (1938); 76 Stat. 72 (1962); 15 U.S.C. § 717c]

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1979

No. 79-1523

TRANSCONTINENTAL GAS PIPE LINE CORPORATION,
Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

On Petition for a Writ of Certiorari to the
United States Court of Appeals for the
District of Columbia Circuit

BRIEF FOR THE RESPONDENT PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK IN OPPOSITION TO PETITION FOR CERTIORARI

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BRIEF FOR THE RESPONDENT PUBLIC SERVICE COMMISSION OF THE STATE OF NEW YORK IN OPPOSITION TO PETITION FOR CERTIORARI

The respondent Public Service Commission of the State of New York (New York), an intervenor in the case below in support of the respondent Commission's

Opinion and Order on the legal issues presented in the present petition for certiorari, herewith files its opposition to the petition for certiorari filed by Transcontinental Gas Pipe Line Corporation (Transco) on March 28, 1980.

STATEMENT OF THE CASE

New York accepts for purposes of consideration of the petition the Statement of the Case contained therein.

ARGUMENT

While the proper treatment of unsuccessful gas supply ventures by natural gas companies, and specifically whether their stockholders or rate payers should bear the costs thereof, or should share therein, is an appropriate matter for Commission consideration in its regulation of pipelines under the Natural Gas Act, 15 U.S.C. § 717, *et seq.*, the argument by Transco in its petition for certiorari that the Commission is required by law to reimburse the pipelines for all such expenditures falling within the "prudency" rubric is without merit. Accordingly, its rejection by the court below does not warrant plenary review by this Court.

As in the case below, Transco's actual position as to its legal rights is not made clear by its petition. It cannot be determined whether Transco is asserting the right to have all expenditures on unsuccessful but prudent plans to enhance its gas supply capitalized as part of its rate base and then amortized over a period of years, in

which event it would secure both a return *on* and the return *of* its investment, or is merely alleging that the Commission was required to allow it to recover its prudent costs. However, while the distinction is important in terms of the costs which would be imposed on gas consumers, the legal insufficiency of Transco's claims applies to the lesser claim as well as to the maximum one.

Specifically, there is no merit to Transco's principal claim, that the substitution of the original cost, prudent investment standard for ratemaking for the fair value, reproduction cost concept originally mandated in *Smythe* v. *Ames*, 169 U.S. 466 (1898), resulted in the elimination of the "used and useful" test of what utility investment was entitled to reimbursement as a matter of law, or to avoid Constitutional confiscation. Nothing in the cases cited by Transco suggests that the Commission is obligated to reimburse a natural gas pipeline for (to say nothing of providing a return on) expenditures, prudent or otherwise, which have not resulted in facilities or operations of use to the consuming public because the utility's rate base is now calculated on the basis of original plant cost rather than reproduction cost. At most, cases such as *Washington Gas Light Company* v. *Baker*, 188 F.2d 11 (D.C. Cir. 1950), *cert. denied*, 340 U.S. 952, suggest that under the end use test of *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944), it lies within the Commission's discretion to permit reimbursement for some unsuccessful expenditures if the risk has not been compensated for in determining the utility's appropriate rate of return and there is some

demonstrable public benefit in requiring gas consumers to pay some or all of the costs.[1]

Nothing in the Natural Gas Act itself supports the Transco position. On the contrary, the Act's requirement in Section 7, 15 U.S.C. § 717f, that pipelines secure advance approval for the construction and operation of jurisdictional facilities connotes a Congressional intent that regulatory screening of the need for and advisability of large capital expenditures precede their imposition upon the company's customers. In conformity with this concept, the Commission does not permit a natural gas pipeline to include in rate base or otherwise recover as a cost of service expense, expenditures for construction work in progress (CWIP) on certificated facilities. Instead, when the facility is placed into service, its cost together with an allowance for interest on funds used during construction (AFUDC) are for the first time recognized in rates. Where the success of the certificated project appears to be doubtful, the Commission has conditioned the grant of the certificate to ensure that the risk of failure will be upon the pipeline. *See Tennessee Gas Pipeline Company*, 48 F.P.C. 149 (1972), *aff'd, Tennessee Gas Pipeline Company* v. *FPC*, 487 F.2d 1189 (D.C. Cir. 1973). Similarly, the Commission, in

[1] *Washington Gas Light Co.* v. *Baker, supra,* involved the question of whether utility customers should continue to pay a return on property which had been dedicated to the public and properly included in rate base but was now obsolete. No issue was raised as to recovery of expenditures never of value to the service provided by the utility.

providing that certain research and development expenditures of a pipeline can be capitalized, regardless of whether these results are used and useful to the pipeline, has provided that such rate treatment is available only where the pipeline first secured approval for the expenditure from the Commission. See 18 C.F.R. § 154.38(d) (5). The fact that the gas supply projects in issue in the present case were not "jurisdictional", since they involved proposed facilities for the production of other than "natural gas", and thus did not require Commission certification, certainly does not give them any preferential position in determining whether the costs could be recovered when the projects aborted.

Moreover, while Section 5 of the Act, 15 U.S.C. § 717d, does not prescribe any general rate making formula for determining a natural gas company's just and reasonable rates (*see FPC* v. *Hope Natural Gas Co., supra,* 320 U.S. at 602), the "used and useful" concept is expressly written into the one facet of rate making—rates of depreciation—for which the Act makes special provision. Pursuant to Section 9(a), 15 U.S.C. § 717h(a), the Commission is authorized to "ascertain and determine, and by order fix, the proper and adequate rates of depreciation and amortization of the several classes of property of each natural gas company *used and useful* in the production, transportation, or sale of natural gas" (emphasis added), and no other depreciation expense may be charged by the company.

It is not necessary for this Court to consider the extent to which the Commission in its discretion may deviate from the used and useful concept. As the

Commission recognized in the orders under review, it has on occasion permitted capitalization and amortization, or only the latter, with respect to capital expenditures by natural gas companies which had not yet resulted in facilities or gas reserves dedicated to service to the company's customers, or even, in some circumstances, had turned out to be unsuccessful or non-productive.[2] In the present situation, however, the Commission concluded that no public considerations existed which would justify assumption of the risk of unsuccessful non-jurisdictional gas supply ventures by the customers rather than the stockholders of the pipeline. Transco has not purported to show that the Commission's policy has inhibited necessary gas supply efforts by it or the other major interstate pipelines, or that the increased risks of such efforts under the Commission's policy are not adequately reflected in the rates of return allowed by the Commission in rate proceedings.[3] Instead the petition for certiorari, as Transco's arguments in the Court below, is limited to the invalid claim that Transco was entitled to recover all prudent but unsuccessful expenditures as a matter of law.

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[2]It is similarly not necessary for the Court to speculate on the reasons why the Commission has on occasion permitted electric utilities to amortize as an expense (but not capitalize) some of the costs of unsuccessful atomic plants. It simply does not follow that what may be an appropriate exercise of Commission discretion under its somewhat parallel responsibilities under the Federal Power Act (which has no provision for advance certification of facilities) necessarily requires identical treatment of expenditures by natural gas pipelines.

[3]In the present case, Transco had agreed by settlement to accept a specified rate of return regardless of the outcome of the issue with respect to its expenditures for unsuccessful efforts.

CONCLUSION

The Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

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No. 79-1523

In the Supreme Court of the United States

OCTOBER TERM, 1979

TRANSCONTINENTAL GAS PIPE LINE CORPORATION,
PETITIONER

v.

FEDERAL ENERGY REGULATORY COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

BRIEF FOR THE FEDERAL ENERGY REGULATORY COMMISSION IN OPPOSITION

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BRIEF FOR THE FEDERAL ENERGY REGULATORY COMMISSION IN OPPOSITION

OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-72a) is reported at 606 F.2d 1094. The orders of the Federal Energy Regulatory Commission[1] (Pet. App. 77a-130a) are not yet reported.

[1] Under Section 402(a)(1)(C), (D), (E), and (F) of the Department of Energy Organization Act, Pub. L. No. 95-91, 91 Stat. 583, 42 U.S.C. (Supp. II) 7172(a)(1)(C), (D), (E), and (F), this agency has succeeded to the relevant functions and responsibilities of the former Federal Power Commission with respect to the certification and regulation of sales of nat-

JURISDICTION

The judgment of the court of appeals was entered on June 20, 1979. A petition for rehearing was denied on October 31, 1979 (Pet. App. 73a-76a). On January 17, 1980, the Chief Justice extended the time for filing a petition for a writ of certiorari to and including March 29, 1980; the petition was filed on March 28, 1980. This Court's jurisdiction is invoked under 28 U.S.C. 1254(1) and Section 19(b) of the Natural Gas Act, 15 U.S.C. 717r(b).

QUESTION PRESENTED

Whether the Commission properly exercised its discretion in holding that a pipeline is not entitled to include in its rate base—and recover the costs of—expenditures for unsuccessful alternate gas supply projects, when such expenditures were not "used and useful" in providing service to jurisdictional ratepayers.

STATUTE INVOLVED

Section 4(a) and (e) of the Natural Gas Act, 15 U.S.C. 717c(a) and (e), are set forth at Pet. App. 131a-132a.

STATEMENT

In July 1974, Transcontinental Gas Pipe Line Corporation (Transco) filed a general rate increase pursuant to Section 4 of the Natural Gas Act, 15 U.S.C.

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ural gas in interstate commerce under the Natural Gas Act, 15 U.S.C. 717-717w. The term "Commission" herein refers to the Federal Power Commission or the Federal Energy Regulatory Commission as the context indicates.

717c, seeking return on, and recovery of, over $22 million it had expended on four unsuccessful projects relating to the production of synthetic natural gas (SNG).[2] Transco proposed to include these expenditures in its rate base and thereby earn a return on them; it sought also to recover the full costs of the unsuccessful projects by including them as expense items in its cost of service, amortizing them over a five-year period (Pet. App. 79a, 80a-81a).

The Commission affirmed the administrative law judge's refusal to grant Transco this rate treatment (Pet. App. 77a-108a).[3] In so ruling, the Commission rejected Transco's argument that because the expenditures were prudent investments, they must necessarily be included within its rate base and in its costs of service (Pet. App. 82a-87a). As the Commission elaborated on rehearing (Pet. App. 121a):

> [E]ven if these SNG project expenditures are assumed to be prudent, rate base inclusion or even Transco's settlement proposal of only cost of service amortization is not necessarily mandated. Part and parcel of the "prudent investment" theory is the "used and useful" requirement; that is, only prudent investment for utility

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[2] Transco had abandoned the projects before completion for a variety of reasons (see Pet. App. 80a-81a n.1).

[3] The Commission also rejected Transco's offer of settlement under which it would have been permitted to amortize the costs of three of the four unsuccessful projects by including them in rates but would forego earning a return on the expenditures by excluding the project costs from rate base (Pet. App. 85a-87a, 123a-124a). The court of appeals affirmed the Commission's ruling (see Pet. App. 62a).

> property which is used and useful to provide service to the utility's customers should be compensated. To say the least, the "used and useful" criterion should not take Transco by surprise, and it would be disingenuous to argue that the SNG studies and coal options for abandoned projects involved herein are "used and useful."

The Commission also concluded that Transco's four projects did not constitute research and development (Pet. App. 83a), and adhered to its firm policy "that SNG expenditures which do not qualify as [research and development] can be recovered, if at all, only through the price paid for actual SNG production sold in interstate commerce" (*id.* at 123a).

The court of appeals affirmed (Pet. App. 1a-72a). It found that the Commission's ruling that the pipeline's ratepayers should not be charged with expenditures that were not "used or useful" in providing service "clearly was a proper exercise of discretion" in the circumstances of this case (Pet. App. 61a).[4]

ARGUMENT

In affirming the Commission's ruling, the court of appeals relied on the doctrine that "for rate base inclusion expenditures must satisfy not only the necessary condition of prudent investment but also must be 'used and useful' in providing service"

[4] On March 3, 1980, this Court denied a petition for a writ of certiorari regarding the separate advance payments issue decided by the court of appeals in this case. *Tennessee Gas Pipeline Co.* v. *FERC*, No. 79-962.

(Pet. App. 62a). Petitioner has submitted no grounds warranting review of that decision by this Court.

1. Petitioner's principal claim (Pet. 10) is "that the used and useful concept is inconsistent with the Commission's prudent investment standard for cost recovery, and when the concepts are applied as a dual test, confiscation of property devoted to public service results." This claim does not withstand analysis.

In *FERC* v. *Pennzoil Producing Co.*, 439 U.S. 508 (1979), this Court recently reaffirmed the well-established proposition that the Commission has wide discretion to determine just and reasonable rates. The Commission's ratemaking authority is not limited simply to deciding whether the "cost[] is not imprudent * * *." *Id.* at 517. On the contrary, the settled rule is that so long as the rate adopted by the Commission is "within a 'zone of reasonableness,'" the " 'courts are without authority to set [it] aside.' " *Ibid.*, quoting *Permian Basin Area Rate Cases*, 390 U.S. 747, 797 (1968).

The "zone of reasonableness" test was clearly satisfied in this case. As the court of appeals correctly observed, it is a "well-rooted regulatory principle" (Pet. App. 31a) that "rate base inclusion expenditures must satisfy not only the necessary condition of prudent investment but also must be 'used and useful' " (Pet. App. 62a).[5] The court below properly

[5] In this regard, the court of appeals referred (Pet. App. 29a) to this Court's decision in *Smyth* v. *Ames*, 169 U.S. 466, 546 (1898), as "articulat[ing] th[is] guiding principle." The

concluded that "[s]ince the projects did not produce any jurisdictional gas" (*id.* at 61a), the Commission's rejection of Transco's rate filing was amply supported under "traditional principles" (*id.* at 31a).[6]

2. Petitioner errs in contending (Pet. 5, 6, 13) that the ruling below is inconsistent with judicial and Commission precedents.

a. In *Tennessee Gas Pipeline Co.* v. *FPC*, 487 F.2d 1189 (D.C. Cir. 1973), the District of Columbia Circuit affirmed the Commission's denial of a pipeline's request for recovery of expenditures on an unsuccessful liquid natural gas (LNG) facility, recognizing that prudency alone is not the sole test for cost re-

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court below explained (Pet. App. 29a-30a; footnotes omitted; emphasis supplied by the court):

> In *Smyth* v. *Ames*, the Supreme Court articulated the guiding principle that "the basis of all calculations as to the reasonableness of rates to be charged by a [public utility] must be the fair value of the property *being used by it for the convenience of the public.*" Although methods for determining values of rate base items have evolved since *Smyth* v. *Ames*, the precept endures that an item may be included in a rate base only when it is "used and useful" in providing service. In other words, current rate payers should bear only legitimate costs of providing service to them. The FPC early adopted the "used and useful" standard and has not departed from it without careful consideration of the wisdom of requiring current rate payers to bear costs of providing future service.

[6] Petitioner suggests (Pet. 5) that the court's opinion afforded insufficient attention to this issue. On the contrary, the fact that the court was able to dispose of Transco's objections to the Commission's denial in a few concise paragraphs underscores the well-established nature of the "used and useful" principle.

imbursement. In that case, the Commission, at the outset, had conditioned its grant of Tennessee's certificate application for construction of the LNG facility to preclude cost recovery in rates if the project ultimately proved to be unsuccessful. The Commission's attention to the "used and useful" principle in imposing that condition is apparent in its underlying opinion. See *Tennessee Gas Pipeline Co.*, 48 F.P.C. 149, 156 (1972); see also the affirming opinion of the court of appeals, 487 F.2d at 1196-1197.

Again, in *Tennessee Gas Pipeline Co.* v. *FPC*, 561 F.2d 955 (D.C. Cir. 1977), the court of appeals affirmed the Commission's elimination of construction overhead costs as a current expense, finding that "these costs are not incurred for the benefit of *present* consumers" (561 F.2d at 958), and concluding that the Commission had properly relied on the "long-established ratemaking policy of charging construction costs only to those consumers who benefit from the new service. This policy rests upon the 'used and useful' test * * *." 561 F.2d at 957. Finally, in *Transcontinental Gas Pipe Line Corp.* v. *FPC*, 518 F.2d 459 (D.C. Cir. 1975), Transco's attempts to include nonrecoverable advance payments in its rate base were rejected. In that case, the court of appeals affirmed the Commission's ruling denying Transco a return on "working capital dedicated to advance payments which, though prudently made, have become unrecoverable." 518 F.2d at 465.

While prudence is indeed a necessary condition to inclusion of expenditures in rate base, the above cases

demonstrate that the "used and useful" test must also be satisfied before jurisdictional ratepayers, rather than shareholders, become obliged to bear the pipeline's business losses.[7]

b. Nor is there a conflict between the panel's decision in this case and another panel's earlier determination in *Washington Gas Light Co.* v. *Baker*, 188 F.2d 11 (D.C. Cir. 1950), cert. denied, 340 U.S. 952 (1951).[8]

The *Baker* decision concerned the choice of permissible (not mandatory) ratemaking policy by an independent local regulatory body—the District of Columbia Public Utilities Commission. In *Baker* the court expressly noted that "the composition of the rate base falls within the province of the Commission under the doctrine of the *Hope* case" [*FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944)]. 188 F.2d at 18. The court interpreted *Hope* as holding that "the Commission may adopt any method of valuation for rate base purposes so long as the end result of the rate order 'cannot be said to be unjust and unreasonable.' " *Ibid.*, quoting from *FPC* v. *Hope Natural Gas Co.*, *supra*, 320 U.S. at 602. This standard

[7] Moreover, the court below correctly observed (Pet. App. 61a n.115) that the Commission's Uniform System of Accounts, 18 C.F.R. Part 201 (originally promulgated in 1939 (4 Fed. Reg. 4764)), provided "clear notice" that the planning costs of abandoned projects contemplated to provide future gas supply would in certain cases be absorbed by pipeline investors, not recovered through rates.

[8] Even if such a conflict did exist it is "primarily the task of a Court of Appeals to reconcile its internal difficulties," not the task of this Court. *Wisniewski* v. *United States*, 353 U.S. 901, 902 (1957).

is in accord with the settled rule as regards the ratemaking policies of the Commission. See, *e.g.*, *FERC* v. *Pennzoil Producing Co.*, *supra*.

Indeed, *Baker* itself demonstrates that the test of prudency is not the sole consideration governing rate base inclusion; the court emphasized that "inclusion in the rate base must meet the test of justness and reasonableness to the consumer, as well as to the investor." 188 F.2d at 19. In any event, subsequent to its decision in *Baker*, the District of Columbia Circuit noted that the so-called "prudent investment" theory does not control rate base formulation under the Natural Gas Act, even though it has been used in local utility regulation in the District of Columbia.[9]

c. Petitioner is also in error in asserting (Pet. 13) that the Commission has a general policy which permits electric utilities to recover expenditures on failed power supply projects. Petitioner refers to the cases of two electric utilities, New England Power Company and Southern California Edison Company, in which the Commission permitted recovery of the costs of specific unsuccessful power supply projects but not inclusion of such costs in rate base. In each instance, the Commission explained the special circumstances in which the costs of the projects were

[9] *Democratic Central Committee of D.C.* v. *Washington Metropolitan Area Transit Comm'n*, 485 F.2d 786, 801-802 (D.C. Cir. 1973), cert. denied, 415 U.S. 935 (1974).

recoverable from ratepayers.[10] These fact-bound cases provide no basis for review of the decision below.

3. In sum, to the extent that Transco is seeking to earn a return on expenditures on its unsuccessful gas supply projects by including such expenditures in its rate base, its request is clearly unwarranted and without precedent. Regardless of the method or theory selected for valuating the rate base—original cost or reproduction costs (see Pet. 12)—the principle remains that property must be in service for the benefit of the ratepayer before it is included in rate base, *i.e.*, before a return is earned thereon. The Commission has used the original cost method of rate base valuation for decades and has concurrently applied the used and useful principle for determining which items should be included in rate base. There is

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[10] In Opinion No. 62, *Southern California Edison Co.*, Docket No. ER76-205 (Aug. 22, 1979), the Commission ruled that Edison's loss on the abandoned Huntington Beach project was not atypical. Because such losses were likely to continue at a consistent level, the Commission concluded that they deserved recognition in Edison's rates as a recurring expense.

Similarly, in Opinion No. 821, *Southern California Edison Co.*, Docket No. E-8176 (Sept. 22, 1977), the Commission had earlier permitted the company to write off expenditures related to its abandoned projects that also were found to deserve treatment as recurring losses.

In Opinion No. 49, *New England Power Co.*, Docket Nos. ER76-304, *et al.* (July 19, 1979), the Commission affirmed the administrative law judge's ruling that the company should not be permitted to earn a return on its investment by including in its rate base expenditures on an abandoned electric generating unit. In that proceeding, all parties agreed, however, that the company should be permitted to recover the cost of the project.

no reason to require it to depart from that position in this case.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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IN THE

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OCTOBER TERM, 1979

No. 79-1523

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Petitioner,

v.

FEDERAL ENERGY REGULATORY COMMISSION,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

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PETITIONER'S REPLY MEMORANDUM

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PETITIONER'S REPLY MEMORANDUM

Significantly, neither the Respondent, Federal Energy Regulatory Commission (Commission), nor the intervenor Public Service Commission of New York (New York) dispute the assertion of Petitioner, Transcontinental Gas Pipe Line Corporation (Transco), that the issue presented is of extreme importance in determining the future role of the gas industry in

meeting the energy needs of this country.[1] Rather, the two opponents to the grant of certiorari make various and sometimes conflicting arguments on the merits of the issue in an effort to convince the Court that the case was correctly decided. While we will await the Court's determination on certiorari and briefing on the merits for a detailed response, the following two points should convince the Court that there is indeed involved here an important area of public utility and constitutional law which needs elucidation by this Court.

1. The Commission's contention (Brief in Opposition at 9) that the "prudent investment" theory of ratemaking is not controlling under the Natural Gas Act is obfuscation at its worst. Ever since passage of the Natural Gas Act, the Commission and its predecessor, the Federal Power Commission, have used nothing but the prudent investment method to regulate gas pipeline rates. Indeed, the very case cited by the Commission for its false proposition[2] makes clear that

[1] Indeed, in its brief to the court below, New York disagreed with the Commission's policy decision to disallow all recovery of prudent expenditures by pipelines because "in a period of gas scarcity pipelines should be encouraged to seek out alternate non-conventional gas supplies. . . ." (New York Br. at 5). New York also supported Transco's settlement offer which would have permitted partial cost recovery by Transco but which was rejected by the Commission and affirmed by the court below with no explanation.

[2] *Democratic Central Committee of D.C.* v. *Washington Metropolitan Area Transit Comm'n.*, 485 F.2d 786 (D.C. Cir. 1973). This was not a Natural Gas Act case, but a local transit case. Respondent does not cite any of its own decisions or any court case arising under the Natural Gas Act for its astounding statement.

the prudent investment method is the method used by the Commission and that this is the method which was affirmed by this Court in the landmark *Hope*[3] case. In the case cited by the Commission, the court stated:

> It seems clear that *Hope Natural Gas* thus adopted the [prudent] investment concept which Justice Brandeis has espoused in *Southwestern Bell.*[4]

2. While the Commission stridently reiterates its claim that the "used and useful" principle is a necessary prerequisite to any cost recovery by pipelines, it lamely characterizes its irreconcilably conflicting treatment of unsuccessful projects of electric utilities as "fact-bound" and proceeds to relegate the claimed factual distinctions to a footnote (Brief in Opposition at 10). The claimed distinctions, even if true, are fatuous. The fact that a utility would continue to suffer losses for unsuccessful projects on a recurring basis, which is the claimed distinction in the two Southern California Edison Co. cases,[5] only serves to emphasize that such projects are not "used and useful" any more than are similar unsuccessful projects of gas pipelines. And the fact that all parties agreed that New England Power Co. should recover its losses for unsuccessful projects certainly would not justify abdication by the Commis-

[3] *Federal Power Commission* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944).

[4] *Democratic Central Committee of D.C.* v. *Washington Metropolitan Transit Comm'n.*, *supra* at 802 n. 135 (citations omitted).

[5] There is no such factual distinction, but even if there were, it would not support the blatant discrimination being practiced by the Commission in its different treatment of gas and electric utilities.

sion of its responsibility to apply what it otherwise claims to be a hard and fast "used and useful" principle. Rather, we suggest that the agreement of all parties in the electric cases is proof that the discriminatory treatment by the Commission of similar projects of gas pipelines is an obvious deviation from the appropriate principles of ratemaking under the prudent investment standard. Only this Court can correct such arbitrary actions of the Commission.

Respectfully submitted,

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BRIEF OF INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA, *AMICUS CURIAE*, IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

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April 8, 1980

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BRIEF OF INTERSTATE NATURAL GAS ASSOCIATION OF AMERICA, *AMICUS CURIAE*, IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI

Pursuant to Rule 42 of the Rules of this Court, the Interstate Natural Gas Association of America (INGAA) hereby files it brief, as *Amicus Curiae,* in support of the Petition for Writ of Certiorari of Transcontinental Gas Pipe Line Corporation (Transco) to review the judgment and opinion of the United States Court of Appeals for the District of Columbia Circuit reported in *Tennessee Gas Pipeline Company, et al.* v. *F.E.R.C.*, 606 F.2d 1094 (D.C. Cir. 1979).

INGAA has received the parties' consent to file the instant brief and has filed with the Clerk of the Court letters so indicating.

STATEMENT OF INGAA'S INTEREST

INGAA is a nonprofit, national trade association representing virtually all of the major natural gas transmission companies operating in interstate commerce in the United States. Insofar as pertinent hereto, INGAA's member companies, which account for approximately ninety percent of all natural gas transported and sold in interstate commerce, are subject to the jurisdiction of the Federal Energy Regulatory Commission (Commission) under the Natural Gas Act, 15 U.S.C. § 717 *et seq.* In this brief in support of the granting of a writ of certiorari, INGAA wishes to emphasize certain points of special concern to the natural gas pipeline industry as a whole.

Commencing in the early 1970's, nearly all of INGAA's member pipelines were forced to curtail deliveries to their customers because of the pervasive shortage of natural gas available to interstate pipelines. In efforts to offset these curtailments of service, many of INGAA's member pipelines have actively pursued the development of supplemental, nonconventional sources of gas supply, *i.e.*, sources other than domestically produced natural gas. Projects of this nature require substantial sums of money, and the ability of pipelines to undertake such financing must not be impaired or precluded by unnecessary or improper obstacles. The decision of the Commission, as affirmed by the court of appeals, represents such an obstacle because of the serious adverse impact it may have on the ability of pipelines to successfully undertake development of needed supplemental gas supply projects. As a consequence, INGAA's members have a substantial interest in this Court's disposition of Transco's Petition for Writ of Certiorari.

ARGUMENT

I. Resolution Of The Question Presented Will Have An Industry-Wide Impact On Gas Pipelines' Ability To Develop Supplemental Gas Supplies.

The specific issue presented by this case is whether Transco will be allowed to recover from its customers its prudent expenditures in several supplemental gas supply projects which were designed to supply gas to those customers, but became unsuccessful and were abandoned. The court of appeals affirmed the Commission's denial of Transco's cost recovery based on its conclusion that "for rate base inclusion expenditures must satisfy not only the necessary condition of prudent investment *but also* must be 'used and useful' in providing service." 606 F.2d 1094 at 1123 (emphasis added). If this dual test for cost recovery is permitted to stand, the decision will have ramifications for the gas industry far beyond the confines of this case because such a test presents a serious impediment, if not an outright barrier, to a pipeline's ability to obtain the venture capital necessary for a high risk supplemental gas supply project. INGAA submits that this result is contrary to the nation's interest in and policy of encouraging the timely development of diverse supplemental energy sources.

The nation is highly dependent upon natural gas as part of its overall energy needs. Since the late 1960's, however, the nation has been consuming known gas reserves at a rate substantially in excess of the rate at which new gas reserves have been found. As a result, it has been necessary for the gas pipeline industry to turn to the development of synthetic gas and other non-

conventional sources in order to enable it to maintain its critical role as a major source of supply of the nation's energy requirements. The development of commercial-scale synthetic gas manufacturing processes is one promising means of fulfilling this role. However, these projects are expensive and high-risk propositions which will require favorable and proper regulatory treatment if the necessary venture capital is to be forthcoming. That some of these attempts will be unsuccessful is inevitable. As previously noted, however, the consequence of the Commission's decision as endorsed by the court of appeals will be to inhibit, if not preclude, access to the venture capital necessary for such projects. Moreover, it is completely at odds with the current efforts of the Congress and the President to mobilize this nation's resources on an unprecedented scale for the development of alternate sources of domestic energy supply.

II. This Case Presents Important Questions Of Confiscation And Discriminatory Administration Of Regulatory Statutes.

In addition to the adverse impact that the decision below will have on gas pipelines' efforts to develop alternative gas supply sources, this case presents the important question of whether the Commission has authority to disallow the recovery of legitimate expenditures by natural gas pipelines of the nature in question herein, while at the same time, and under effectively an identical statute, it routinely allows electric utilities subject to its jurisdiction to recover their costs of failed and abandoned projects. INGAA submits that disallowance of the recovery of such legitimate expenditures by gas pipelines, absent a finding of imprudence, is unconstitutionally confiscatory.[1] Furthermore, such inconsistency in rate making treatment by the Commission unfairly discriminates in favor of electric utilities which properly are allowed to recover their costs of failed and abandoned projects.[2] Since gas pipelines and electric utilities are both involved in supplying the energy needs of this country, the Commission's improper action in this regard will have the unwitting effect of favoring one source of energy over another. Moreover, since natural gas in the more efficient and environmentally preferred source of energy, the competitive advantages which the Commission's inconsistent ratemaking treatment will bestow upon electric utilities, whose new projects consist largely of proposed nuclear units or coal-fired generating units, is questionable at best.

Given (i) the current and projected energy requirements of the nation, and (ii) the conflicting precedents issuing from the Commission in contemporaneous cases involving ratemaking treatment for unsuccessful or abandoned gas and electric projects, it is extremely important that this Court provide benchmarks defining the constitutional limits of the Commission's authority under comparable statutory schemes with

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[1] *See West Ohio Gas Co.* v. *Public Util. Comm'n*, 294 U.S. 63 (1935).

[2] Subsequent to the Commission's decision in the instant case, it has issued three electric rate opinions which permitted the recovery of costs of power supply projects that were ultimately abandoned. *See Southern California Edison Co.* (Opinion No. 62), —— FERC ——, [1979] 18 FED. POWER SERV. 5-980; *New England Power Co.* (Opinion No. 49), —— FERC ——, [1979] 18 FED. POWER SERV. 5-484; and *Southern California Edison Co.* (Opinion No. 821), —— FPC ——, [1977] 13 FED. POWER SERV. 5-163.

respect to appropriate ratemaking treatment for prudent utility expenditures. As circumstances now stand, and as the Commission's inconsistent decisions reflect, cost recovery for unsuccessful projects by utilities subject to the Commission's jurisdiction turns not on whether the project becomes "used and useful" but, rather, simply upon whether the affected company is a gas or electric utility. Such a result cannot be allowed to stand on either lawful or equitable grounds.

CONCLUSION

Because of the importance of the questions presented, INGAA respectfully submits that this Court should grant the writ of certiorari.

Respectfully submitted,

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